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Budgetary policy tools for economic recovery

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DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

EUROPEAN PARLIAMENT'S SPECIAL COMMITTEE ON THE FINANCIAL, ECONOMIC AND SOCIAL CRISIS

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NOTE

Abstract

Budgetary policy affects economic prospects both through a demand channel, with macroeconomic effects that depend on the net balance in the public sector accounts, and through various supply effects which are more microeconomic in character. The latter depend on various dimensions of the composition of public spending and revenue raising, and give rise to issues concerning the quality of public finances. This paper explains the different mechanisms involved, considers how the quality of public finances can be enhanced in the recovery and discusses how the sustainability of public finances can be assured as part of a recovery strategy.

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1. THE MECHANISMS OF BUDGETARY POLICY

Budgetary policy operates at a number of levels in contributing to economic recovery and in mitigating the effects of the economic crisis, as well as in shaping the long-term sustainability of the economy. The first, most obviously, is in providing a source of demand to offset the decline in spending by other sectors of the economy (notably consumption spending and private investment, especially if it happens unexpectedly). This first channel is macroeconomic and takes two main forms: automatic stabilisers and discretionary fiscal stimuli of the sorts seen in the recovery packages adopted by most EU Member States over the last two years. Other channels through which public finances affect the economy are on the supply-side, sometimes subsumed under the heading of the quality of public finances. They are predominantly microeconomic in character, but can also encompass strategic changes that recast the role of the public sector.

As a shock that has seen a sudden downturn in demand, the crisis has different roots in different Member States, and some of the decisions taken in the early stages of response to the crisis partly reflected the character of the slide into recession. In some, such as the UK, high levels of personal sector indebtedness led to a reversal of consumer demand as consumers sought to reduce net debt. Economies highly dependent on exports (such as Germany or Sweden), by contrast, were disproportionately affected by the sudden seizing-up of world trade. How spending and taxes are best reconfigured will be influenced by such diagnoses.

1.1. The demand side

The crisis has seen a rapid re-appraisal of the role of budgetary policy in economic management. Simplifying a little, the model in place prior to 2008 was that monetary policy should be the instrument to deal with shocks affecting the euro area (EU27)[1] as a whole, while fiscal policy would be used to deal with asymmetric shocks affecting single Member States. However, as the crisis intensified, it rapidly became clear that a discretionary fiscal stimulus was needed to complement monetary policy action. In normal times, automatic stabilisers would be enough to provide a budgetary cushion, though the magnitude will depend on the extent to which the expenditure and tax bases are sensitive to the downturn.

The joint effect of automatic and discretionary fiscal shifts is to offset a decline in private sector economic activity. The extent to which either form of fiscal policy stimulus contributes to recovery depends on its magnitude relative to GDP and the second order, multiplier effects that result from the spending of workers who would otherwise be unemployed. There is considerable uncertainty about the size of these multipliers and there has, as an illustration been heated debate around the Obama stimulus package about how much is to be expected. Christina Romer, who chairs the US Council of Economic Advisers, estimated in early 2009 that the multiplier could be higher than 1.0, implying that the effect on GDP would be up to twice the size of the stimulus package. Her figures are, however, considerably higher than estimates from previous analyses of fluctuations in public spending which suggest a short-term multiplier of 0.4 rising to 0.6 in a second year.[2]

The multiplier will, moreover, depend on how the stimulus package is targeted: if it flows mainly to sectors with high levels of unemployed factors of production, the multiplier will be higher than if the stimulus crowds out other activities. In both the recovery and 'exit' phases of the crisis, there will be more impact if the fiscal stimulus takes account of such multiplier effects.

[1] Plainly, the incomplete euro membership complicates this stylisation of the policy model, but even in large economies such as the UK, active fiscal policy was not much used.
[2] Becker, G. (2010) blog posted 03/01/2010 at http://uchicagolaw.typepad.com/beckerposner

However, it has to be borne in mind that, in some cases, the unemployed resources are the direct result of excess capacity or past imbalances and that targeting a stimulus at such sectors may blunt the impact of market signals. In countries where the downturn has been especially severe in the construction industry, for example, a relatively higher multiplier could be expected by stimulus spending that employs construction workers than one which raises demand for products in which there are fewer unemployed workers, but only if there is sufficient unmet demand and no overhang of property.

1.2. Deficit and debt implications

Other things being equal, both automatic stabilisers and a discretionary fiscal stimulus will increase the public sector deficit and, more so when GDP itself is falling or stagnating, increase public debt as a proportion of GDP. Eventually, the debt has to be repaid, either by having higher taxes than would otherwise have been the case or curbing public spending. This process of fiscal consolidation takes demand out of the economy and therefore calls for careful sequencing in the design of exit strategies, and also has a multiplier effect associated with it. The consequences of consolidating through expenditure cuts rather than tax increases also merit attention. Cuts in public spending tend to be more effective than tax increases in achieving enduring improvements in public finances. However such cuts are best introduced gradually rather than in the more dramatic packages that some governments have adopted. Consolidation is also facilitated if it is undertaken in a manner that accelerates growth enhancing structural reforms.

Tax increases may be easier to impose in the short-term, but have a number of drawbacks. Estimates by specialists such as Robert Barro suggest that there is a high multiplier associated with tax increases which would amplify the dampening effects on economic activity of a consolidation. There is also a presumption that high taxation is a disincentive to increased economic activity, although the notion of optimal taxation as the level needed to finance necessary public goods is also germane. The difficulty in applying such concepts is that there is no easy way of determining empirically where the optimal boundary between public and private activity lies, and the wide range across the EU in the pre- and post-crisis sizes of national public sectors is striking. However, the weight of evidence is that GDP growth rates are negatively correlated with the size of the public sector as a proportion of GDP. In addition, the fiscal effects of debt service have, so far, been relatively muted because of very low interest rates – even for those Member States that have been penalised by financial markets by being obliged to pay an interest premium. But as interest rates return to more 'normal' rates, the cost of debt service will rise, adding to the improvement that will be needed in primary balances to achieve consolidation.

Public assets are another dimension of budgetary policy that can be expected to loom large as recovery takes hold. Many governments were obliged, in the initial stages of the crisis, to re-capitalise banks and, in so doing, they acquired substantial quantities of bank shares. The value of assets acquired by governments as a result of bail-outs is uncertain and there are methodological problems around how best to measure them. There are further methodological problems and market uncertainties associated with guarantees and contingent liabilities[3]. If, nevertheless, it is assumed that governments will eventually want to dispose of the involuntarily acquired equity in banks, they could obtain very substantial sums from selling-off these assets – possibly even making capital gains – thereby easing debt problems. The experience of Sweden following the financial crisis of the early 1990s suggests that a re-privatisation could provide a strong improvement in public accounts[4].

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[3] For an extended discussion, see Part II, chapter 1 of the Commission report on Public Finances in EMU - 2009

[4] Jonung (2009) maintains that, in the end, the net fiscal cost of the bank crisis was close to zero, although he also cites much more dramatic costs for other systemic banking crises.

Underlying all these issues are governance questions about the manner in which budgetary policy is set, monitored and – where it becomes relevant - disciplined. In particular, the circumstances in which it becomes necessary to exercise control of excessive deficits and, for the members of the euro area, to push for adherence to the Stability and Growth Pact constraints need careful examination in a period of macroeconomic volatility.

1.3. Supply-side effects of budgetary policy

There are several other consequences of budgetary policy that derive more from the composition of public spending and taxation in how they affect shorter- and longer-term economic prospects, as well as the social consequences of the crisis. In the short-term, difficult choices have to be made between policies which support sectors of activity or social groups worst affected by the crisis. Budgetary choices made in the present can, however, also shape the durability of the recovery and the long-run sustainability of public finances.

The composition of public spending can be approached in a number of ways. There is, first, a dichotomy between public investment and public consumption which, while analytically obvious, is often difficult to reconcile with practice. The state also plays a major role, through social protection systems, in inter-household redistribution. Several categories of spending that, under standard accounting conventions, are classified as public consumption can nevertheless have enduring effects. Education, for example, is crucial for the enhancement of human capital. Indeed, empirical work suggests that public spending on human capital formation (education and training) is associated with higher growth[5].

By contrast, redistributive outlays can undermine growth by curbing incentives to work or the willingness of individuals to invest in training and skills enhancement. Moreover, some publicly-funded schemes that look like attractive options in the short-term (such as early retirement as a means of cushioning job losses) can have adverse effects on long-run growth potential by reducing the stock of human capital and creating a higher pension burden. Yet it is important to recognise that without sufficient social spending, inequalities are likely to worsen and social cohesion will be compromised. From a political economy standpoint, limits to curbs on redistributive policy are to be expected, not least because solidarity is an established norm in EU social models.

It is also important not to overlook the ‘productive’ role of social protection in risk management and in promoting labour market flexibility. In a period of crisis, the different sorts of ‘transitions’ that occur in the labour market are likely to be more prominent than in more normal times. A higher proportion of the labour force will be subject to moves from regular, stable employment into unemployment, temporary or part-time work, or from activity into inactivity. Well-designed social protection can help to smooth transitions and thus to mitigate processes that are destructive of human and social capital.

Another issue is the extent to which public spending is growth enhancing and there has been much discussion in the context of the stimulus packages adopted by different countries of whether or not the measures taken will plant the seeds of future growth or facilitate transformations, such as towards a growth model characterised by lower intensity of carbon emissions. Economic theory provides two broad sets of explanation for growth. The first stresses factor accumulation, with the growth of the capital stock, especially, as the variable that accounts for differences between countries. Technology is considered exogenous and is freely available to all economies and economic agents. An economy that succeeds in increasing its stocks of capital and labour will grow. The second class of theories starts from the proposition that the technology variable is not exogenous, but is instead the result of specific characteristics of the economy, including policy choices.

[5] Afonso et al. (2005)

A related way of looking at public expenditure derives from the notion of the quality of public spending, a notion that was already pre-occupying policy-makers before the crisis struck[6]. In general terms, this poses the question of whether what is spent for a specific policy purpose has spillover effects on other policy objectives. Many examples can be identified. Well-designed active labour market policies can ensure that victims of the crisis remain connected to the labour market, and thus avoid the debilitating effects of 'hysteresis'[7], whereas purely passive income support can aggravate imbalances in the labour market. Public spending can also have diverse effects over time, with implications for long-run fiscal sustainability. A pension reform may have sizeable initial costs, yet if it results in a lowering over subsequent years of pension costs it could be considered money well-spent. Similarly, investments in information and communication technologies or energy savings that require immediate expenditure can lead to long-run gains in the productivity of public services (and thus lower future public spending), while also lowering costs for private actors.

A further distinction within public spending is between the volume of public services purchased and (especially) the labour costs incurred in producing these services. Increases in public spending are often accompanied by some real increase in the incomes of public sector workers. However, the link between pay and productivity also has to be borne in mind. The strong reactions of unions in Greece, Spain, Portugal and elsewhere to recent measures aimed at reining-in budget deficits demonstrate the potential for disruption from attempts to cut public pay. Yet in a crisis, public sector workers are often in a relatively privileged position compared with private sector workers, and it can be argued that some of the burden of adjustment that the economy as a whole needs should be borne by these workers in the form of lower compensation.

2. THE NATURE OF STIMULUS PACKAGES

After some initial hesitation, most Member States introduced quite substantial stimulus packages. The European Economic Recovery Plan (EERP) encouraged governments to choose from a range of revenue and expenditure options that reflected their country-specific circumstances. Not all Member States contributed to the EERP because their already precarious fiscal positions made a discretionary stimulus difficult and some Member States have even been obliged to initiate fiscal consolidations before recovery is in sight. The annex table, reproduces the latest Commission update of the size and composition of national packages. In addition, some fiscal stimulus was provided by the EU budget, through bringing forward €6.25 billion of spending as part of the European Economic Recovery Plan.

2.1 The national stimulus packages

The national stimulus packages differed in a number of ways and analyses of them have been provided by various agencies. Box 1 present a summary based on assessments carried out by the Commission. This shows that there are substantial differences in the priorities that Member States favoured.

One dimension of stimulus packages that has received particular attention is their contribution to environment-friendly initiatives and investments. The sheer diversity of these and problems of definition preclude a clear statement of their share of the packages. Nevertheless, according to a Commission paper[8], as much as a quarter of the stimulus packages is aimed at the needs of the future and will 'contribute to a more innovative, knowledge based, low-carbon economy'.

[6] For example, the work of the Economic Policy Committee, brought together in Deroose and Kastrop (2008)
[7] This can be defined as the process by which extended periods of unemployment undermine the employability of the individual, resulting in a diminished scope for them to be employed when vacancies re-emerge.
[8] Commission (2009) 'Progress on the implementation of the European economic recover plan – June 2009'

Several governments have explicitly favoured discretionary spending for 'green' purposes, with allocations for a diverse range of actions (for details, see also Saha and von Weisäcker, 2009).

A sizeable proportion is variations on car scrappage schemes which, to the extent that they encourage the replacement of 'dirty' cars by more fuel-efficient, modern cars, can be regarded as supportive of a transition to lower carbon emissions. However, they also have a carbon cost in manufacturing of the new vehicles and encouraging car use, so that there needs to be some circumspection in the claims.

Spain's stimulus package, for instance, under the heading of 'sector-specific' initiatives, includes €600 million for the environment and allocations for sustainable tourism, although €800 million under the same heading goes to support the car industry. Germany's package included €2.8 billion to promote carbon-friendly renovation of houses, and measures worth €1 billion for corporate innovation and energy efficiency. Nearly a quarter of the Polish package is for investment in renewable energy, representing around 0.12% of Polish GDP, while some 10% of the Dutch stimulus package is for green growth measures, including the promotion of energy efficiency and other green-related innovations.

Box 1 Commission assessment of stimulus packages

The Commission notes that 'discretionary public spending is in general considered to have a stronger positive impact on demand in the short run than tax cuts, as consumers might prefer to save rather than consume'. For this reason, there might be a preference for expenditure-related measures. But the Commission also observes that 'provided that tax cuts are (expected to be) limited in time, thereby avoiding neutralising anticipatory effects of larger tax liabilities in the future, and delivered directly and upfront, the effect on consumption could still be substantial'. In its assessment, the Commission also draws attention to other measures taken by Member States that do not directly affect the budgetary position, the bulk of which have been the various forms of guarantees offered to the financial sector.

The measures which can be considered pursue the following aims:

- Various approaches to boosting the purchasing power of consumers, including cuts in. personal taxes and social security contributions, direct income support for households, cuts in particular consumption taxes, energy subsidies, supporting for housing or property markets and temporary cuts in VAT. The Commission finds that 'the great majority of Member States have adopted measures' in this category, with the EU aggregate in this category amounting to 0.5% of GDP – just over a third of the total stimulus packages.
- Increased spending on labour market policies, such as wage subsidies and intensifying active labour market policies. The Commission comment is that 'few Member States have adopted noteworthy measures in this area', with Poland and Sweden having adopted the most emphatic measures, amounting to 1% of GDP in 2009, compared to an EU-27 average of just 0.2%. Hungary and Denmark stand out in 2010 with 2% and 1% respectively.
- Reduction of taxes, social security contributions, and other measures directly aimed at business, such as tax breaks, earlier payment of VAT returns, facilitating company financing, state aid and stepping up export promotion were adopted in almost half of all Member States. Slovenia, Cyprus and Romania stand out in this category, with stimulus measures worth well over 1% of GDP in 2009, compared with an EU-27 average of 0.3%
- Increased public investment (targeted at infrastructure enhancement, promotion of projects associated with greening the economy, and improving energy efficiency) were adopted in close to half of all Member States. As a proportion of GDP, the highest figures in 2009 were in Malta (1%), Poland (1.1%), Spain (0.9%) and a handful of countries with a rate of 0.4%, compared with an EU-27 average of 0.3%

Source: Commission (2009) *Public Finances in EMU – 2009* and Commission (2009) 'Progress on the implementation of the European economic recover plan – December 2009'.

2.2 The EU budget

The role of the EU budget in recovery is, at best, marginal for both arithmetic and structural reasons. At 1% of EU GNI it cannot be expected to have a major impact, especially given the obligation to be in balance every year. Structurally, the EU budget is dominated by multi-annual programmes which afford only limited scope for flexibility in the timing of spending, so that although efforts to 'front-load' spending are commendable, the sheer lags in accelerating the implementation of projects means that not much extra demand can be injected into the system quickly. Moreover, any acceleration of EU spending would oblige Member States to increase the amounts they transfer to the EU, because of the manner in which the GNI resource functions. In principle, therefore, increased Member State deficits could be used to fund higher spending from the EU budget, leaving the EU account in balance. However, there is unlikely to be much appetite for this in national finance ministries already struggling to hold down deficits.

Thus, although minor changes can be envisaged in the composition of spending funded by the EU budget, it would not make a noticeable difference to recovery strategies at a macroeconomic level. The €5 billion package agreed for investment in energy and broadband (using unspent money from the EU budget) in spring 2009 is an illustration: even if it is regarded (probably incorrectly) as 'new' money, it amounts to just 0.04% of EU GDP, compared with the gross aggregate fiscal stimulus for all twenty-seven Member States in 2009 of 1.4% of GDP[9], with a further increase expected in 2010 of 1.3%. The automatic stabilisers are estimated to have an aggregate effect of 3.2% of GDP over the period 2009-2010, so that the total fiscal stimulus from national sources is of the order of 5% of GDP, once the offsetting effects of fiscal consolidation measures adopted by a number of countries are taken into account.

There may, nevertheless, be some scope for the EU budget to be re-orientated towards public goods that – for whatever reason - are both under-supplied by Member States and might contribute to long-run growth. Examples are cross-border infrastructure developments needed to complete transport, energy and communication networks, or projects to promote a low-carbon economy. Some such projects can generate 'double dividends' by providing 'smart' solutions to long-term aims such as clean energy technologies. For many major projects, there are cross-border spillovers that mean that individual Member States cannot appropriate all the benefits of investments, potentially deterring them from investing.

[9] Commission (2009) 'Progress on the implementation of the European economic recover plan – December 2009'

3. IMPROVING THE QUALITY OF PUBLIC FINANCES

Public investment has an important role in promoting growth and has been associated in some econometric work with very high rates of return, although other findings are much more circumspect[10]. Particularly in a context in which there is an imperative of shifting the EU towards a low-carbon paradigm, public investment can have a profound influence by over-coming blockages that will not easily be dealt with by the private sector. In addition, public investment can have a catalytic effect in triggering higher private investment, so that the leverage ratio of possible schemes should be considered. Inevitably, some public projects have proved to be very wasteful, so that it is important not to assume that any and all public investment is growth enhancing. In this regard, the governance challenge in a recovery programme is to have suitable controls, such as ex-ante impact assessment or rigorous cost-benefit analyses, and to have a target rate of return for investment.

Public investment should also be seen not just as high visibility new projects, but should encompass the effective maintenance and upgrading of the existing stock of public capital[11], which may often provide better value for money.

Recent work on tax and growth[12] suggests that there is a hierarchy in the influence of tax structures on growth. Corporate taxes are most harmful, followed by personal income taxes and expenditure taxes, while property taxes are most growth-friendly. The policy implication is that, for a given revenue requirement, it is better to switch from direct income taxes to property taxes, while also loading more of the burden of taxation on to expenditure taxes. However, the evidence also suggests that reductions on tax rates for small businesses do not have much effect, whereas high rates of personal tax can adversely affect entrepreneurial activity. In addition, expenditure taxes tend to have a greater impact on less well-off people than cuts in progressive income taxes, though the poorest tend to be less affected, especially if national systems have exemptions for the likes of basic foods. Avoiding frequent changes in taxation also has its merits, since temporary measures may lead to increased uncertainty on the part of private investors or consumers that has destabilising effects. Indeed, predictability in budgetary policy is seen as a virtue by many commentators.

Several elements enter into any assessment of what sort of changes to consider. The fall in private investment that invariably occurs in a downturn can be offset by tax cuts or allowances that favour investment. Subsidies for durable goods, such as the car scrappage schemes that many governments have implemented, may bring forward spending, but result in a subsequent decline in sales at a time when recovery is precarious. Cuts in expenditure taxes (such as the early UK decision to reduce the VAT rate temporarily) can very rapidly put money in consumers' pockets and thus sustain spending at a time when consumers might be inclined to retrench. However, it is important to explore the true incidence of such a cut: sellers may simply use the tax cut to improve their profit margins by keeping prices unchanged, while consumers might save any windfall gains rather than maintaining their level of spending. Analysis of the UK's temporary cut in VAT as a stimulus measure is, nevertheless, quite positive about the benefits, arguing that in a period of sharp downturn, many of the reservations about such cuts are misplaced[13].

[10] One of the most widely quoted early studies (by Aschauer, 1989) found substantial effects, but subsequent work has challenged his findings. As Shioji (2001) notes, 'the empirical evidence on public capital productivity is mixed, to put it mildly', with many panel data studies showing poor returns on public capital investment.

[11] Kalaitzidakis and Kalyvitis (2004) find that redirecting pubic funds to maintenance of public capital, rather than new projects can often achieve better results for growth.

[12] For example in an OECD working paper by Johansson, Heady, Arnold, Brys and Hartia (2008)

[13] Barrell and Weale (2009)

Although it is not easy to identify a single optimal strategy for 'better quality' public finances, the broad directions suggested by research are summarised in box 2. This list points to ways in which governments seeking to use the opportunity of the crisis to improve the quality of public finances could move. It is, plainly, not a one-size-fits-all formula, but can serve as useful guidance.

Box 2 Criteria for high quality fiscal policies that support growth

While there are always going to be differences that reflect national traditions and specific circumstances of Member States, some broad orientations for budgetary policy are summarised here. They reflect prevailing, but by no means uncontested views, suggesting the following lessons for policy-makers:

- They should help to maintain sound public finances and an institutional environment supportive of growth. This is a long-term objective and the challenge in the recovery stage will be to judge when to revert to a stability orientation without hitting demand.
- Limit government activity to the provision of essential goods and services for which the state is the optimal provider, while leaving non-essential activities to private actors. This message may be harder to maintain in the wake of the evident market failures of recent years in the financial sector, but it is also important not to allow the pendulum to swing too far in the opposite direction.
- Establish growth promoting incentives for the private sector and efficient use of public resources. Clearly, in those Member States where the deterioration of budget positions is structural, an additional burden is imposed on the rest of the economy. At the same time, there is a need for governments to ensure that public services are delivered efficiently and offer value for money.
- Comprise an efficient and stable system for raising revenue, in which uncertainties about tax are minimised and in which the distortions that inevitably arise in any tax systems are kept in check.
- Offer a stable macroeconomic framework in which there is coherence between monetary policy, structural policy and budgetary policies.

Sources: Afonso et al. (2005); Commission (2008); own elaboration

3.1 Sustainability of public finances – the longer term challenges

Sustainability of public finances is under scrutiny not just because of the rise in debt and deficit ratios, but also because of possible changes in the underlying determinants of the robustness of public finances and complications in how they are measured. The distinction between cyclical and structural deficits warrants attention. For some Member States, the deterioration in public finances has come about partly because the crisis has either undermined revenue or led to enduring demands on public expenditure – both structural, rather than cyclical phenomena. The clear corollary is that growth will not suffice to restore the public finances to health; instead, remedial measures to boost tax revenues or to reduce public spending commitments will be needed.

The strong message emanating from the Commission on sustainability is that even when the crisis is over, the spectre of ageing will re-assert itself. Indeed, the threats to fiscal sustainability are compounded by the conjunction of crisis and ageing. Estimates suggest that even an annual fiscal consolidation of 0.5% of GNI per annum will not suffice to bring down debt and that the risks will be aggravated if a consequence of the recession is a legacy of slower growth[14].

[14] See the briefing paper for CRIS by Börsch-Supan [IP/A/CRIS/NT/2009-06)

Usually, a cyclical downturn is compensated by above average growth in the subsequent recovery, but the fear is that the intensity and character of the present crisis could constitute a structural break in what the Commission calls 'growth conditions'[15].

Over the next twenty-five years the budgetary cost of ageing is estimated to be 2.5% of GDP[16]. While not dramatic, as more of the cost comes after 2020 than in the next decade, there is still a long-term challenge to be met. It can be met by raising the employment rate, achieving net improvements in the public sector balance sheet (reducing net debt) and by reform of the delivery of pensions, long-term care and health care for the elderly.

The challenge with major pension reform is that there are inevitable transition costs associated with maintaining the current system while asking contributors to start building-up funds for a new system. Governments therefore have to assume some of the immediate burden, while the cost to individual contributors is diverted to a new scheme. If well-designed, the savings to public finances come through relatively quickly, but in a period of tight public finances, the difficulties in implementing this kind of reform are manifestly exacerbated.

Sustainable public finances will also be shaped by the determinants of future growth. In particular, as ageing results in more older workers retiring from the labour market than new entrants coming into it, (already evident, for example, in Finland), the imperative of raising output per worker can be expected to loom larger. In these circumstances, productivity increases become more vital than labour market entry in underpinning growth: once remaining 'reservoirs' of labour are used, raising productivity is the solution. Yet with a well-educated population, the scope for human capital enhancement is subject to diminishing returns, so that increased effort is likely to be needed in boosting physical and intangible capital.

[15] Commission (2009) *Sustainability Report 2009*

[16] For the latest projections, which have to be interpreted with some caution because of the sheer uncertainties involve, see the 2009 ageing working group report (Commission and EPC, 2009).

4. CONCLUSIONS: IMPLICATIONS FOR THE NEXT STAGES OF RECOVERY STRATEGIES

Achieving a satisfactory and sustainable rate of growth will be central both to recovery in the level of employment and to the restoration of sound public finances. An obvious message for public finances is that they have to move well beyond the immediate 'Keynesian' stimulus that has been paramount up to now to concentrate on key supply-side effects. Particular attention should be paid in the next stages of recovery to public investment, especially in areas which are known to be the most effective in promoting growth, such as R&D, human capital, and appropriate infrastructure.

The next stages of budgetary policy – as the initial stimulus packages were – have to be tailored to the circumstances of the Member State. In planning the medium-term trajectory of public spending, governments will plainly have an opportunity to push forward environmental initiatives and other agenda for transforming economies. Budgetary measures consequently have to be designed to reach the desired sectors of the economy, be they consumers, businesses or particular sectors, and there is also an argument that the measures should avoid undue distortion of the economy. Yet some distortion may also be desirable, notably to promote transformations, such as towards a low-carbon economy or to curb evident imbalances (such as the over-bearing influence of the financial sector in certain Member States)[17].

The rapid increase in budget deficits and public debts triggered by the crisis are, rightly, high on the agenda of all finance ministers. However, sound public finances are more than just about bringing these ratios down; they also concern the efficiency with which the public sector uses its resources and the quality of the services it provides. In a period in which public finances are under strong pressures for rapid consolidation, possible consequences for structural reform have to be looked at with care. Especially where reforms are sorely needed, an undue emphasis on tight budgets could slow reform efforts[18]. A further consideration is how easy it is to diminish or even reverse any new measures, given the evident need to consolidate public finances fairly quickly once solid growth returns.

The resort to budgetary policy to 'rescue' economies has inevitably increased the share of the public sector in the economy. Experience across the EU shows that economies can perform well with very different levels of public sector activity. Nevertheless, as well as consolidating the net positions for public deficits and acting to reduce public debts, lowering the aggregate share of the public sector is likely to be on the agenda for a number of years, and governance changes should be explored. Given that one way of reducing the share of the public sector in the economy is to constrain public sector pay, governments may have to countenance politically difficult confrontation with public sector workers.

Evidence suggests that in turbulent periods, the quality of fiscal institutions can be pivotal (Aron, 2000), the implication of which is that a wide-ranging look at the governance of budgetary policy should be on the policy agenda. It follows that policy-makers will need to take a fresh look at institutional quality in public finance. Fiscal rules and other elements of the fiscal framework will need to feature in the long-term decisions that governments have to take. Golden-rules, constitutional prohibition of deficits (as enacted for Germany with the 2016 target, or already in place in Estonia), medium-term frameworks, or variants on public service contracts are examples of tools that can be used.

[17] The chairman of the UK Financial Services Authority, Adair Turner, has recently referred to some facets of finance as 'socially useless'.

[18] Beetsma and Debrun (2003) put forward a simple model showing the linkages between structural reforms and fiscal deficits, and show that where there is a tight budget constraint, it is likely that structural reforms with slow pay-offs – however, persuasive the case for implementing them – will be avoided in favour of those that bear fruit more immediately and have lesser budgetary implications.

ANNEX TABLE: OVERVIEW OF DISCRETIONARY STIMULUS IN MEMBER STATES

	Fiscal policy												
	Change in fiscal balance (aggregate over 2008-10)[1]	Discretionary stimulus in 2009 [2]					Consolidation measures in 2009	Discretionary stimulus in 2010 [2]					Consolidation measures in 2010
		Overall (gross terms)	Out of which,					Overall (gross terms)	Out of which,				
			measures aimed at households	increased spending on labour market	measures aimed at businesses	increased investment expenditure			measures aimed at households	increased spending on labour market	measures aimed at businesses	increased investment expenditure	
	p.p. change	in % of GDP	in % of GDP	in % of GDP	in % of GDP	in % of GDP	in % of GDP	in % of GDP	in % of GDP	in % of GDP	in % of GDP	in % of GDP	in % of GDP
BE	-4.6	1.2	0.4	0.2	0.2	0.1	0.1	1.2	0.5	0.4	0.0	0.1	-0.6
BG	-3.0	0.1	0.0	0.0	0.0	0.0	-3.3	1.0	0.4	0.6	0.0	0.0	-3.3
CZ	-3.4	2.3	0.7	0.6	0.7	0.4	-0.7	1.4	0.7	0.0	0.6	0.0	-1.2
DK	-8.2	0.5	0.0	0.3	-0.1	0.0	0.0	1.5	0.0	1.0	0.1	0.0	0.0
DE	-5.0	1.8	0.6	0.2	0.5	0.4	0.0	2.5	1.3	0.3	0.4	0.5	0.0
EE	-0.4	0.4	0.0	0.4	0.0	0.0	-8.8	1.6	0.0	0.9	0.0	0.8	-7.9
IE	-7.5	0.7	0.4	0.0	0.2	0.0	-4.8	0.9	0.4	0.1	0.3	0.0	-6.5
EL	-4.6	0.2	0.1	0.1	0.0	0.0	-1.7	0.0	0.0	0.0	0.0	0.0	0.0
ES	-6.0	2.3	0.5	0.1	0.8	0.9	-0.3	0.8	0.2	0.0	0.1	0.5	-0.9
FR	-4.9	0.9	0.3	0.1	0.3	0.2	0.0	1.1	0.3	0.0	0.8	0.1	0.0
IT	-2.6	0.7	0.2	0.2	0.3	0.0	-0.9	0.5	0.0	0.2	0.2	0.1	-0.5
CY	-6.6	2.2	0.9	0.0	1.4	0.0	0.0	1.0	0.7	0.0	0.3	0.0	0.0
LV	-8.1	1.8	1.7	0.0	0.0	0.0	-4.5	0.5	0.3	0.0	0.2	0.0	-8.4
LT	-5.9	0.0	0.0	0.0	0.0	0.0	-8.7	-0.1	0.0	-0.1	0.0	0.0	-14.0
LU	-6.7	2.4	1.5	0.3	0.3	0.2	0.0	2.2	1.4	0.0	0.5	0.3	0.0
HU	-0.5	0.5	0.0	0.5	0.0	0.0	-0.7	2.1	0.0	2.1	0.0	0.0	-2.2
MT	0.3	1.6	0.0	0.2	0.5	1.0	-1.8	1.3	0.0	0.3	0.4	0.5	-2.1
NL	-6.8	1.3	0.2	0.2	0.3	0.3	-0.2	1.4	0.2	0.2	0.2	0.4	-0.1
AT	-5.0	1.4	1.1	0.3	0.0	0.1	0.0	1.7	1.3	0.3	0.1	0.0	0.0
PL	-3.8	2.2	0.0	1.0	0.2	1.1	-1.5	2.7	0.0	1.0	0.1	1.6	-0.3
PT	-5.3	1.0	0.2	0.2	0.2	0.4	0.0	0.3	0.2	0.0	0.1	0.0	0.0
RO	-1.2	1.9	0.2	0.1	1.6	0.0	-4.2	0.1	0.0	0.1	0.0	0.0	-9.8
SI	-5.2	2.4	0.0	0.2	1.9	0.3	-1.1	0.5	0.0	0.4	0.1	0.0	-1.1
SK	-3.7	0.4	0.2	0.1	0.0	0.1	-0.5	0.5	0.3	0.1	0.1	0.1	-1.1
FI	-9.0	1.4	1.0	0.0	0.2	0.0	0.0	2.1	1.5	0.0	0.5	0.1	-0.1
SE	-5.8	1.0	0.2	1.0	-0.2	0.0	0.0	2.1	1.2	1.0	-0.1	0.0	0.0
UK	-7.8	1.7	1.3	0.1	0.3	0.0	-0.1	0.7	0.4	0.2	0.1	0.0	-0.6
EU27	-5.2	1.4	0.5	0.2	0.3	0.3	-0.4	1.3	0.5	0.2	0.3	0.3	-0.5

Source: Commission (2009) ‘Progress on the implementation of the European economic recover plan – December 2009’

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