

# WHAT ROLE WITHIN THE EU FRAMEWORK DOES THE QUALITY OF PUBLIC FINANCES HAVE?

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## **Abstract**

*The contribution describes how the quality of public finances and its improvement might contribute to the priorities of the Lisbon strategy, which (among other issues) emphasizes the importance of sustainability of public finances and their quality for the fulfillment of the objectives of the strategy. The contribution describes which role within the public finance enhancement is played by the national states and their policies and which role is played by the policy of EU as a whole; this is viewed both from the macro-economic and micro-economic perspective. Last but not least the attention is paid to the quality and sustainability of fiscal reforms, functioning of institutions and procedures, whose functions are the control of public expenditures and their efficient reallocation according to the strategic priorities and objectives.*

## **Key words**

Public finance quality, fiscal policy, long-term growth, public expenditure composition, cost-benefit analysis, performance budgeting, fiscal consolidation

## **Introduction**

The Lisbon strategy has highlighted the strategic importance for improving both the sustainability of public finances and their quality. However, while the EU fiscal framework lays down the principles and procedures for achieving fiscal sustainability, the principles for improving the quality of public finances have not yet been integrated in a systematic way within the framework of EU policy co-ordination or within the EU fiscal framework.

The article focuses on the conceptual issues of quality in the EU framework of economic policy co-ordination. It proposes a broad definition of the quality of public finance and views the topic of quality from different perspectives in order to identify possible policy instruments. The analysis focuses on a *macro-economic perspective* that concentrates on the link between fiscal policy and long-term growth. It analyses the potential contribution of composition of public expenditure and revenue, and also the possible interaction between size of the public sector and the long-term growth rate is mentioned.

*The micro-economic perspective* focuses on the tools and institutions that can be helpful for enhancing the quality of public finances in practice. The last part shows how strategies for better controlling public expenditure, fiscal consolidation on the expenditure side and reallocating funds to their best uses can contribute to long-term growth.

## **The definition of quality**

The overall objective of the Broad Economic Policy Guidelines (BEPGs) as the overarching instrument for economic policy making in the EU are defined in the Treaty, art.98: "...The Member States and the Community shall act in accordance with the principle of an open market economy with free competition, favoring an efficient allocation of resources....". Article 2 then provides a list of objectives that includes "to promote economic

and social progress and a high level of employment and to achieve balanced and sustainable development...”.

Within this general framework, the co-ordination of fiscal policies at the level of the EU is geared towards ensuring sound public finances. This includes aggregate fiscal discipline as well as the principle of automatic stabilisation over the economic cycle. Apart from these macro-economic functions, national budgets also perform the function of the allocation of public resources. It is generally accepted to examine budgetary policies “*in three dimensions*” that has been proposed by [3]:

- to ensure fiscal control and fiscal discipline;
- to provide a degree of stabilisation of the economy;
- to promote allocative and technical efficiency in service delivery through procedures that provide incentives for greater productivity.

The first requirement aims remains particularly important in the euro zone given the need for consistency between national fiscal policies and the single monetary policy as well as in the European Union as whole given the need to cater for the costs of ageing. The second requirement also remains particularly important given that the single monetary policy can only be geared towards the euro zone as a whole so that national fiscal policies need to be able to react flexibly to asymmetric economic developments. At the level of the EU, the most urgent task has been to achieve enhanced co-ordination of the macro-economic function of national budgets. Once that budget systems are able to fulfill the requirements of aggregate discipline and a degree of stabilisation, it will be possible to devote more attention to allocative and technical efficiency.

By taking the three dimensions of budgeting it becomes possible to propose a definition of the concept of quality, **where the quality of public finances concerns the allocation of resources and the efficient and effective use of those resources in relation to identified strategic priorities [7, p.167]**. The advantage of using this definition is that it focuses on the link between public expenditure and policy objectives, while it does not specify the policy objectives *ex ante*. It is the role of political process to prioritise the objectives, and the role of budgeting to achieve these objectives in the best way. Regarding the priorities the EU Lisbon strategy includes sustainable growth, full employment, social cohesion and competitiveness.

### **A macro-economic perspective on quality**

A full discussion how quality of public finances would contribute to the objectives of the Lisbon strategy would go beyond the scope of this article, it concentrates to the link between fiscal policy and long-term growth only.

All studies on the link between fiscal policy and the long term-growth start from Solow’s neoclassical growth model that implies that in the long run steady state growth rate is constant and driven by exogenous factors of population growth and technological change. Fiscal policy can only affect the level of output in the steady state and the adjustment path through its impact on savings. One of the criticisms of the neoclassical growth model points out that it is difficult to find reasons in these models why the government -should intervene at all. Endogenous growth models therefore allow the possibility of government intervention for correcting market failures when there are externalities. This leads to the conclusion that investment in human and physical capital may affect the steady-state growth rate. This point can be illustrated on the basis of the production function [9]:

$$Y_t = f[A_t K_t, B_t L_t] \quad (1)$$

where  $t$  is time,  $Y$  is output,  $K$  and  $L$  are capital and labour and  $A_t$  and  $B_t$  represent the quality of the stock of labour and capital.

This equation states that total output at any moment in time depends on the volume and productivity of capital and labour.

In the neoclassical model, the production function exhibits decreasing returns to both capital and labour and  $A_t$  and  $B_t$  are exogenous. Consequently, the economy will tend to a constant capital/labour ratio, where the return from additional investment equals its costs. When, by contrast, endogenously determined increases in  $A_t$  and  $B_t$  ensure that the marginal product of physical capital does not tend to zero when the amount of capital per worker increases, policies that affect the incentives to invest in either physical or human capital can have permanent effects on the long-run growth rate.

The basic message for fiscal policy is summarized in table 1 where “productive” expenditure is defined as expenditure with a positive effect on the marginal productivity of capital and/or labour ( $A_t$  and  $B_t$  in equation 1), while distortionary taxes are taxes that distort the decision to invest in capital or labour and hence might have negative growth effects.

**Table 1:** Fiscal policy aggregates and long-term economic growth

<b>Budgetary aggregates</b>	<b>Classification</b>	<b>Theory: effect on growth</b>	<b>Possible examples</b>
<b>Expenditure</b>	“Productive”	Positive effect on the marginal productivity of capital and labour	Investment in transport and communication, education and research and development, health care
	“Unproductive”	Effect on marginal productivity zero or negative	Expenditure on economic services, recreation
<b>Taxation</b>	“Distortionary”	Distorting supply or demand of capital and labour	Taxation on income and profit
	“Non-distortionary”	No distortion of supply or demand of capital and labour	Proportional tax on consumption

Source: [7, p.169]

The findings of existing studies confirm the importance of taking into account both the costs (i.e. higher taxation) and benefits (i.e. reaching policy objectives) of public spending to undertake a meaningful analysis of such links. The major difficulties that have been encountered in existing empirical studies concerns the question of which expenditure should be considered as “productive” (i.e. growth enhancing) and which are instead to be classified as “unproductive”. Although there is a degree of agreement that a few categories of public expenditures can quite safely be included among “**productive**” public expenditure because there are directly aimed at productivity improvements (e.g. **public infrastructure investment, education and research and development**) there is no consensus among researchers concerning the impact of most expenditure items on long-term growth. This lack of consensus is reflected by the fact that available estimates of “productive” expenditure in the EU range between 5% and 44% of the total public expenditure, depending on which expenditure categories are seen as “productive”.

These large differences in empirical data points out a fundamental problem that empirical macro-economic studies face: data that correspond to the theoretical classification

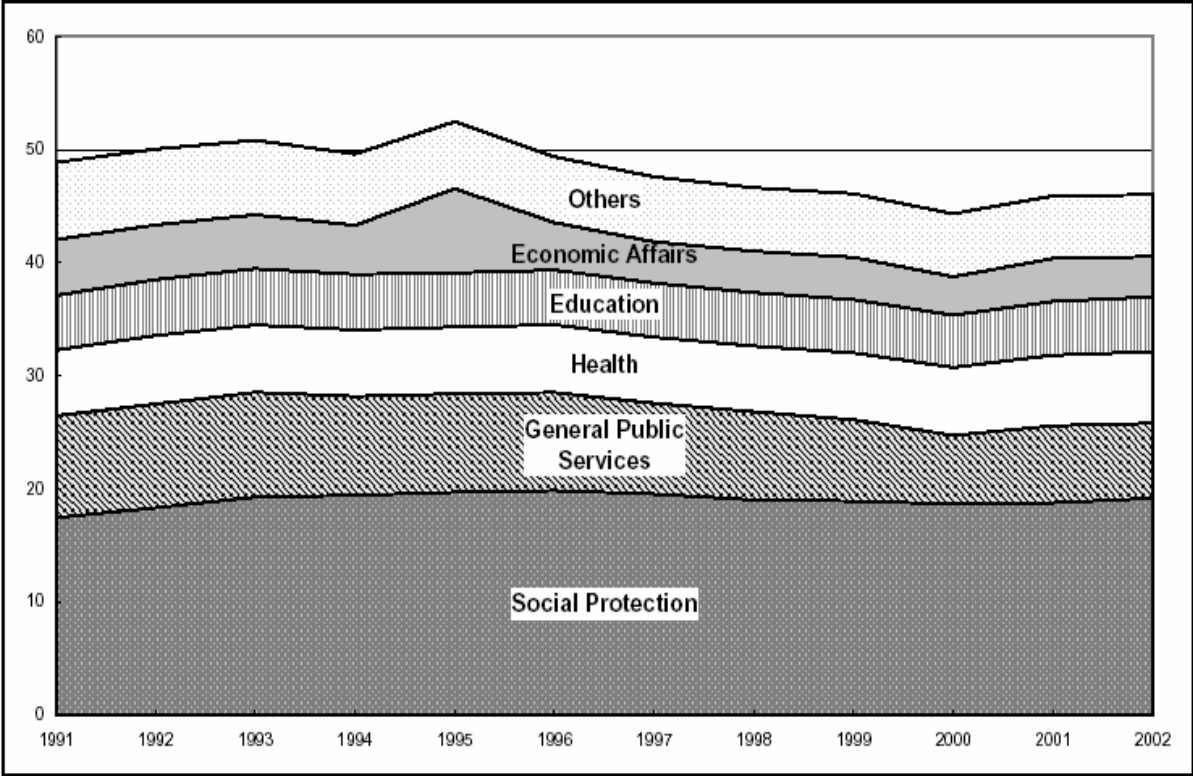
into “productive” and “unproductive” expenditure or taxation are not available at the macro-economic level. Instead, data available in national accounts have to be used, either on the basis of the economic classification or on the basis of functional classification, while assuming that all expenditure in a particular category is either “productive” or “unproductive”. Thus, the macro-economic approach may be useful to identify budgetary categories that are on average more “productive” or distortionary than others, but in the end all government intervention has to be investigated individually with respect to its design and the question of whether or not its benefits outweighs its costs. This should be identifying on the bases of cost-benefit analysis.

▪ **The composition of public expenditure**

A macro-economic approach has also been adopted to investigate patterns and determinants of re-composition of public expenditure across EU countries. It focuses on two questions:

- how did the composition of public expenditure change over time;
- and what may have been driving factors of changes in the composition of public expenditure?

The outcome for the Member States<sup>1</sup> for which data were available shows, that, over period of 1991-2002, **social protection** and **health-care expenditure** increased their share in total expenditure, while the latter as a percentage of GDP has gone down. For more details see [7].



Source: [7, p.169]

**Graph 1:** The composition of expenditure as a % of GDP

<sup>1</sup> no data for new Member States are available

This suggests that the main drivers of expenditure composition over medium/long-term are the underlying upward pressures such as those related to ageing and that the discussion on re-allocating funds in line with priorities cannot abstract from such ongoing tendencies. The long-term projections for age related expenditure show that upward pressures on public spending can be expected to intensify further, while at the same time there would be little scope for strategies of raising additional revenues given already high ratios of total revenues to GDP. This increases the importance of a clear focus on spending priorities and an efficient and effective use of public resources in reaching them.

▪ **The size of the public sector**

The possible correlation between the size of public sector and long-term economic growth, and the robustness of this correlation, is subject to a lively debate in the economic literature. Some studies e.g. [8] show a negative association between total revenues and the trend growth rate for EU countries. They link this debate to the quality of public finances and recommended reducing the burden of taxes and social contribution on income (along with shifting public spending to “productive” uses). On the other hand, other studies e.g. [2], [4], [10] show for different cross sections of countries that the partial correlation between the size of the public sector and growth is not robust to the inclusion of other explanatory variables of long-term growth.

We mention only the position of EU Member States with respect to several possible interpretations of the link between the size of public sector and the long-term growth rate and we show whether such interpretations are supported by empirical data.

- **Catching up: countries with a lower initial GDP per capita might show higher trend growth rates;**

The empirical data confirms a negative correlation between initial income (GDP per capita) and the long-term growth rate. On average, new Member States grows faster than existing Member States, which had a higher initial income.

- **Wagner’s law: the demand for government services and hence the size of the public sector might increase with level of income;**

One might expect that the demand for government services will grow as countries become richer. Thus, countries that have already higher per capita GDP would be expected to have a larger public sector. However, the empirical data don’t completely confirm this pattern. Many EU countries with similar level of GDP per capita show large differences in the size of their public sector. Some researches draw attention to the fact that Wagner’s law may operate especially at low levels of income and that the relationship may break down at the highest levels of income.

- **Differences in preferences across countries: countries with a stronger preference for income equality have a larger public sector and lower degree of income inequality;**

Empirical data confirm a negative correlation between the size of the public sector and the degree of income inequality. They show that differences in the size of the public sector between the Member States can be explained by differences in preferences for income redistribution.

- **Distortionary taxation: after a certain point, the negative effects of taxation outweigh the positive effects of “productive” spending on trend growth;**

The data confirm that on average countries with smaller public sector have recorded higher growth rates in recent years. At the same time the data confirm that on average countries with smaller public sector had a lower initial GDP.

As a result, it is difficult to disentangle the effects of distortionary taxation and catching up on long-term growth. Finally, differences in preferences regarding the income distribution (equity) also play a role in explaining differences in size.

### **A micro-economic perspective on quality**

The macro-economic perspective on quality helps to underpin the strategic importance of redirecting public expenditure towards “productive” uses and reducing distortionary taxation. It can only provide for a broad generalisation on the question of separating “productive” from “unproductive” expenditures in practice. Here becomes useful the approach of the micro-economic perspective as it provides the tools needed to support decision making in practice. This entails a shift in focus from cross-country differences in fiscal aggregates towards the techniques and institutions that can be used to improve the quality of public finances, i.e. the effective and efficient use of resources in reaching strategic priorities. The technique of cost-benefit analysis (CBA) provides for the essential criterion for distinguishing between “productive” and “unproductive” public investment in practice.

#### ▪ **Cost-benefit analysis**

A comprehensive theoretical description of the use of CBA is outside the scope of this article. In principle, the use of CBA allows for the comparison across projects in their contribution to social welfare. In practice, however, methodological differences in the application often complicate such comparisons. Therefore, at the national level, many countries have undertaken efforts during the last years to harmonise the methodology used for project appraisal. For example, in the Netherlands a large-scale research project was undertaken on the use of CBA in analysing large infrastructure projects with the aim of improving the scientific basis for decision making. In the United Kingdom, the new edition of the “*Green Book, Appraisal and Evaluation in Central Government*” incorporates revised guidance to encourage a more thorough, long term and analytically robust approach to appraisal and evaluation. At the level of EU, CBA of investment projects is explicitly required for larger projects concerning the Structural Funds, Cohesion Fund and the Instrument for Pre-Accession Countries. While Member States are responsible for the prior appraisal, the Commission has to evaluate the quality of this appraisal in order to admit the project proposal to co-financing and to determine the co-financing rate. In this context, DG Regional Policy has recently updated its *Guide for CBA of investment projects* [European Commission, 2002].

In sum, both at the national level and also within the European Commission, efforts have been undertaken to improve the use of CBA as a decision-making tool for identifying “productive” projects. The evidence suggests that further improvements can be made, in particular with respect to the valuation (in monetary terms) of social costs and benefits in different sectors.

#### ▪ **Performance budgeting**

As indicated, full CBA is used especially for large investment projects with a long time horizon, while performance budgeting offers the opportunity of extending the use of cost-benefit comparisons to all or to a large part of government expenditure, by systematically relating the benefits of governments intervention (what is the objective?) to its costs (i.e. public expenditure to reach a particular policy outcome). Several Member States have introduced reforms to the budgetary process that aim at achieving society’s priorities in the most efficient and effective way by linking public expenditure to policy outcomes. The

question is whether these reforms have indeed produced the desired effects. The discussion on this question can be summarised on the basis of three main elements of performance budgeting:

- **A clear ex ante specification of the performance (outcomes /outputs) expected for each programme or agency**

In practice it may not always be possible to describe policy outcomes in a measurable and specific way and therefore not establish direct causal links between performance and budget appropriations.

- **Devolution of decision-making authority and freedom to reallocate funds towards “productive” items.**

The philosophy in performance budgeting is to shift attention from control ex ante on budgetary inputs to accountability ex post on the basis of results. A relaxation of input controls can give managers and agencies more freedom to agencies to use their expertise in finding and designing the best programmes.

- **A link between performance and budget appropriations**

This is the crucial issue. In this respect, we can distinguish two definitions of performance budgeting. Broadly defined, a performance budget is any budget that presents what agencies have done or expect to do with the money provided to them. Strictly defined, a performance budget is only a budget that explicitly links each increment in resources to an increment in outputs or other results. In practice many countries that measure performance have avoided a direct link between performance and budget appropriations.

For more detail of current practices in EU Member States see the survey based on answers provided by national authorities to the OECD/World Bank survey of budget practices and procedures that was launched in February 2003 [7, pp. 188-189]. The survey was set up in a way to obtain information on the extent to which countries *measure* performance and also on the *use* of the data in the decision-making process.

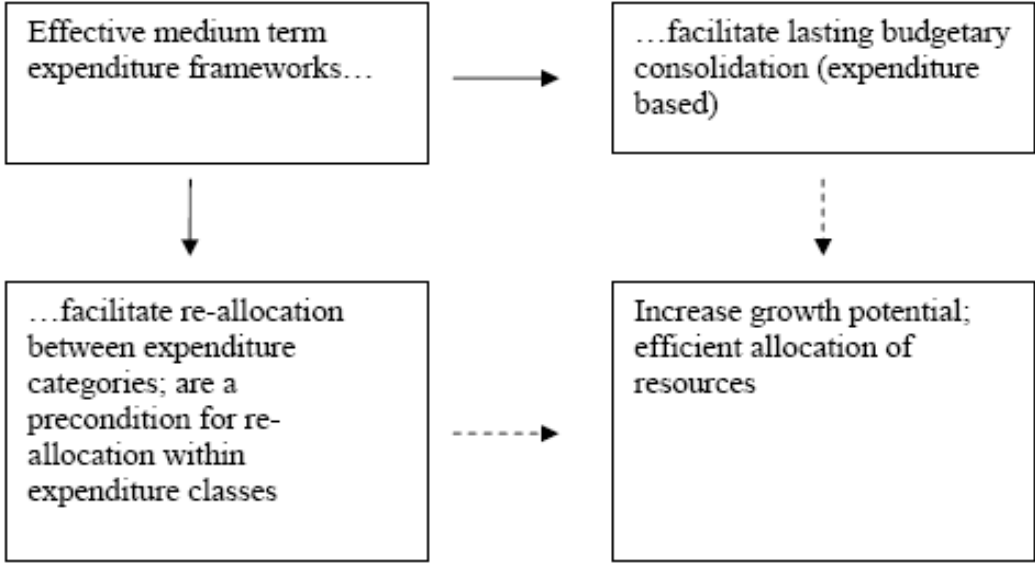
Results range from practices quite close to the strict form of performance budgeting in Spain, to more broad forms in the Netherlands and the Nordic countries, a middle group of countries which use performance data but not for all programmes and several countries that do not use performance data at all. In majority of countries, performance data is used in determining budget appropriations, but there is no evidence that appropriations are related to results in a direct manner. As regards the use of sanctions when performance data are not met, results generally show that sanctions are absent.

### **Expenditure control and fiscal consolidation**

Improving the quality of public finances requires that resources are reallocated in line with strategic priorities. In the previous section we discussed that effective medium-term expenditure frameworks are a precondition for increased managerial flexibility to reallocate funds to their most “productive” uses *within* broad expenditure classes. Effective medium-term expenditure framework can also facilitate the political decision-making process of re-allocation funds *between* broad expenditure categories.

These two aspects of the link between expenditure control and reallocation are summarized in the left two boxes of graph 2. The analysis shows that only countries with effective control of broad categories of expenditure will be able to pursue a successful strategy of giving managers the freedom to reallocate resources within broad expenditure categories. The graph 2 also contains the hypothesis that the use of these medium-term

expenditure limits for each spending sector or major spending department may facilitate reallocation between broad expenditure categories.



Source: [7, p.191]

**Graph 2:** The consistency of expenditure control and quality

The empirical evidence in European Commission [6] on fiscal consolidation suggests that fiscal adjustment based on expenditure cuts is more likely to coincide with higher growth rates than consolidation periods based on tax increases. Furthermore, some studies [1] point out that fiscal consolidation efforts based on expenditure cuts, especially where they focus on reducing transfers and government wages, are more likely to have a lasting effect on budget deficits than consolidations based on higher revenues.

The top two boxes of Graph 2 contain hypothesis that countries with more effective medium-term expenditure frameworks might be able to better control public expenditure and thus might be more likely to show fiscal consolidation on the expenditure side of the budget than countries with less effective institutions for controlling public expenditure.

The implementation of such strategies of expenditure-based fiscal consolidation depends not only on the introduction of the appropriate budgetary institutions, but also requires the political will to do so.

As shown in graph 2, the combinations of these hypotheses indicate how effective control of public expenditure through properly designed medium-term expenditure frameworks might foster not only fiscal discipline, but also the quality of public finances by facilitating the reallocation of existing funds as well as lasting expenditure based fiscal consolidation.

In this respect, the data show that many of the countries that had established a track record of expenditure control – while at the same time strengthening budgetary institutions that aim at using existing funds better - have almost immediately used the increased room for manoeuvre and slackened the reins in recent years.



## Conclusion

According to the definition proposed at the beginning of the article, enhancing the quality of public finances requires the allocation of budgetary resources and the effective and efficient use of those resources towards identified strategic priorities. With respect to the priorities of the Lisbon strategy, the analysis in this article concentrates on the link between fiscal policy and long-term growth. Overall, it confirms the relevance of reallocating public expenditure towards “productive” uses and lowering the burden of distortionary taxation in a context where priority is given to raising the growth potential of the EU economy. At the same time we stressed the importance of micro-economic analysis on the question of separating what is “productive” from what is not. In the article we analyse not only trends regarding the composition of public expenditure at macro-economic level but also the role of cost-benefit analysis, the contribution of budgetary institution to better using existing funds and the role of medium-term expenditure frameworks as a precondition for reallocation of expenditure *within* broad categories, while at the same time facilitating the political decision-making process on reallocation of expenditure *between* broad categories.

The article stresses that issues related to the composition of the budget are a national competency, but the EU has an important role to play encouraging public finances that are supportive of the objective of the Union, in particular of the Lisbon strategy.

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