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My region, My Europe, Our future:
The seventh report on economic, social and territorial cohesion

{COM(2017) 583 final}

CHAPTER 5 - National policies and Cohesion

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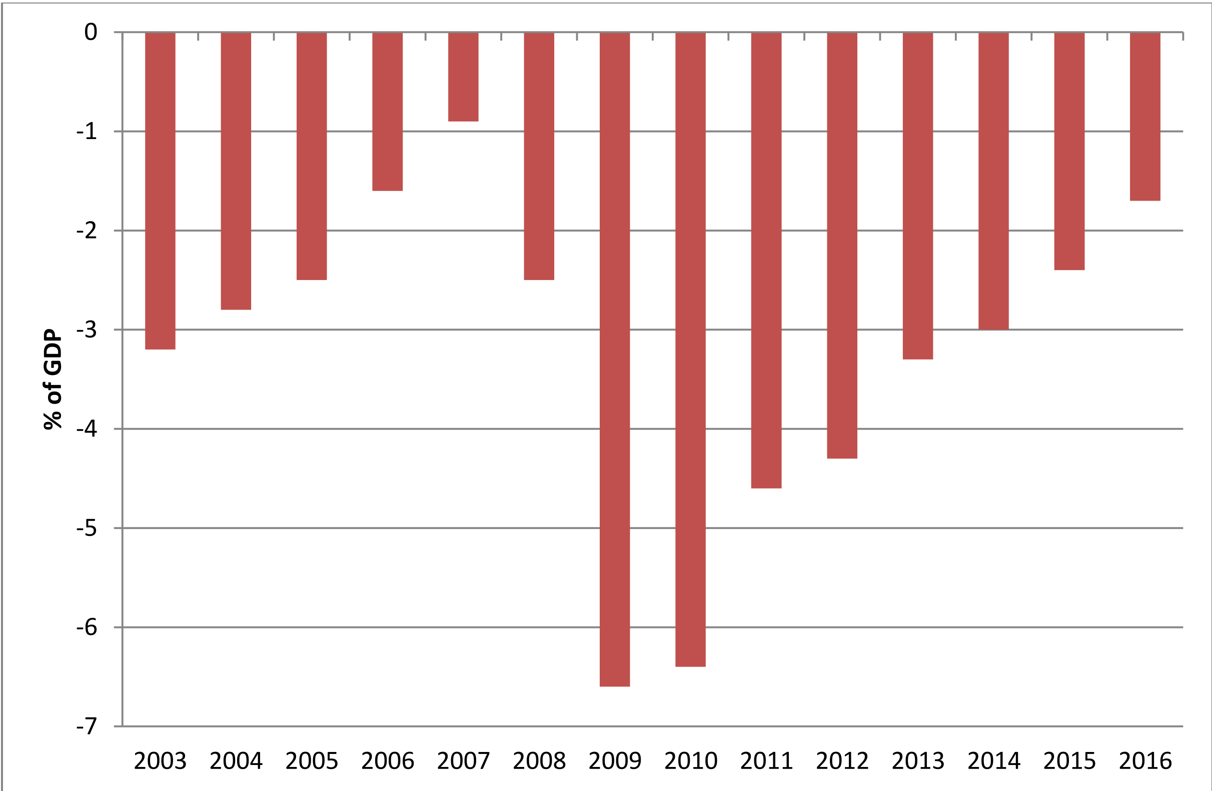
5.1. PUBLIC INVESTMENT IS STILL AT VERY LOW LEVELS DESPITE THE RECENT PICK-UP OF THE EU ECONOMY

5.1.1. Government balances have improved considerably over the recent past

The Sixth Cohesion Report reported a significant worsening of public finances as a result of the sharp economic downturn which started in 2008. This is reflected in a substantial general government deficit of over 6% of GDP in both 2009 and 2010 on average across the EU as compared with one of less than 1% of GDP two years earlier in 2007 (Figure 5-1).

From 2011 onwards, the deficit was reduced as a result of increased fiscal consolidation and gradual economic recovery from 2014 on. In 2014, the deficit averaged 3% of GDP, the maximum allowed under the Stability and Growth Pact, and it then declined to 2.4% of GDP in 2015 and 1.7% in 2016. Of the 20 Member States or more which were subject to Excessive Deficit Procedures in 2011, only 5 were are still subject in 2016 (Spain, France, Greece, Croatia and the UK).

Figure 5-1 General government balance, EU-28 average, 2000-2016

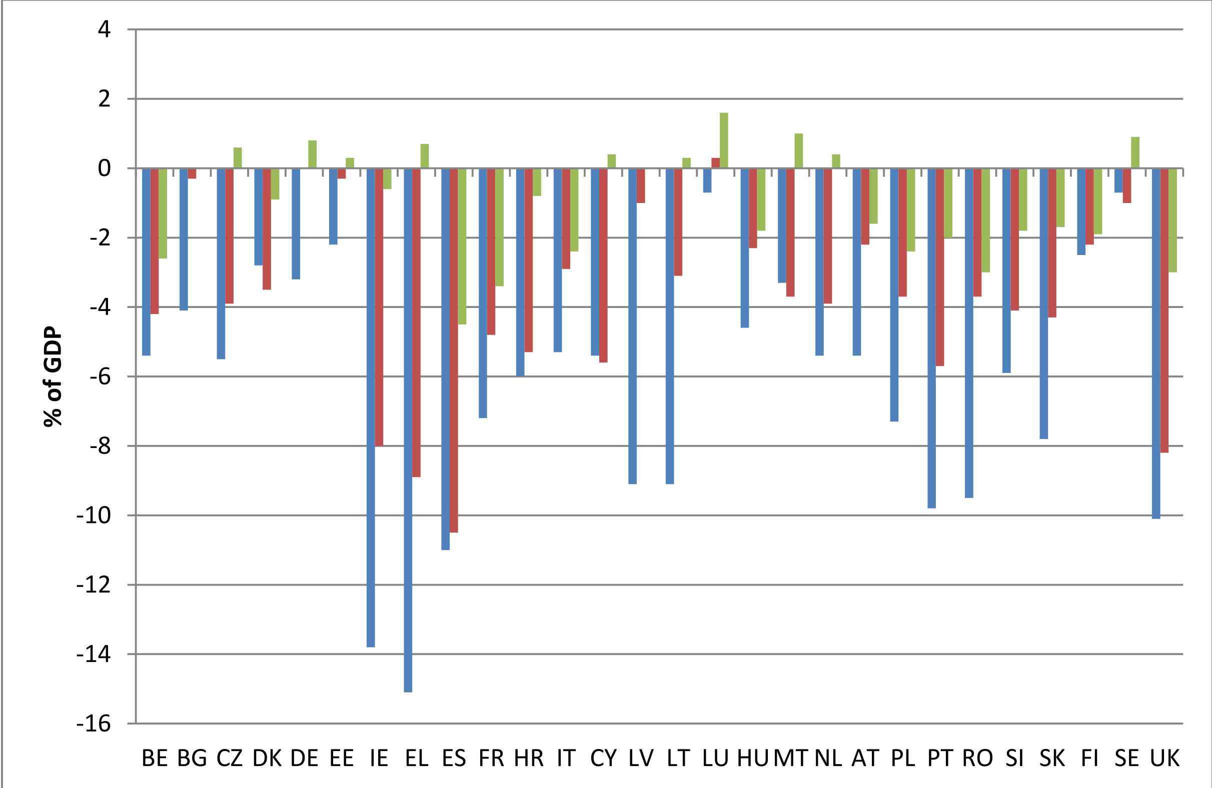


Source: Eurostat

A similar pattern to the average is evident in almost all Member States, though to differing extents. In those hit hardest by the economic downturn, the reduction in the fiscal deficit started from levels as high as 13% of GDP in Ireland and 15% in Greece, though in a number of other Member States, the deficit never went above the 3% allowed under the Stability and Growth Pact (Figure 5-2). The fiscal consolidation effort has been impressive in Greece and Ireland, in particular, with the government balance being improved by more than 15 percentage points of GDP between 2009 and 2016. It has enabled public finances to return to a sustainable path, which is a pre-condition for sustained and sustainable economic recovery.

The widening of the deficit in 2009 and 2010 was due mostly to stagnating revenues and a sharp increase in government expenditure (Figure 5-3), the combined result of automatic stabilisers and one-off measures adopted as part of Economic Recovery Packages. Most of the latter did not remain in place beyond 2010 and, as a result, there was a gradual decline in government expenditure relative to GDP, which was then further reduced by the automatic stabilising effect of the gradual economic recovery [1] (lower expenditure and increased revenue). Again, the same pattern is evident in most Member States but with significant differences in scale because of variations in the depth of the economic downturn.

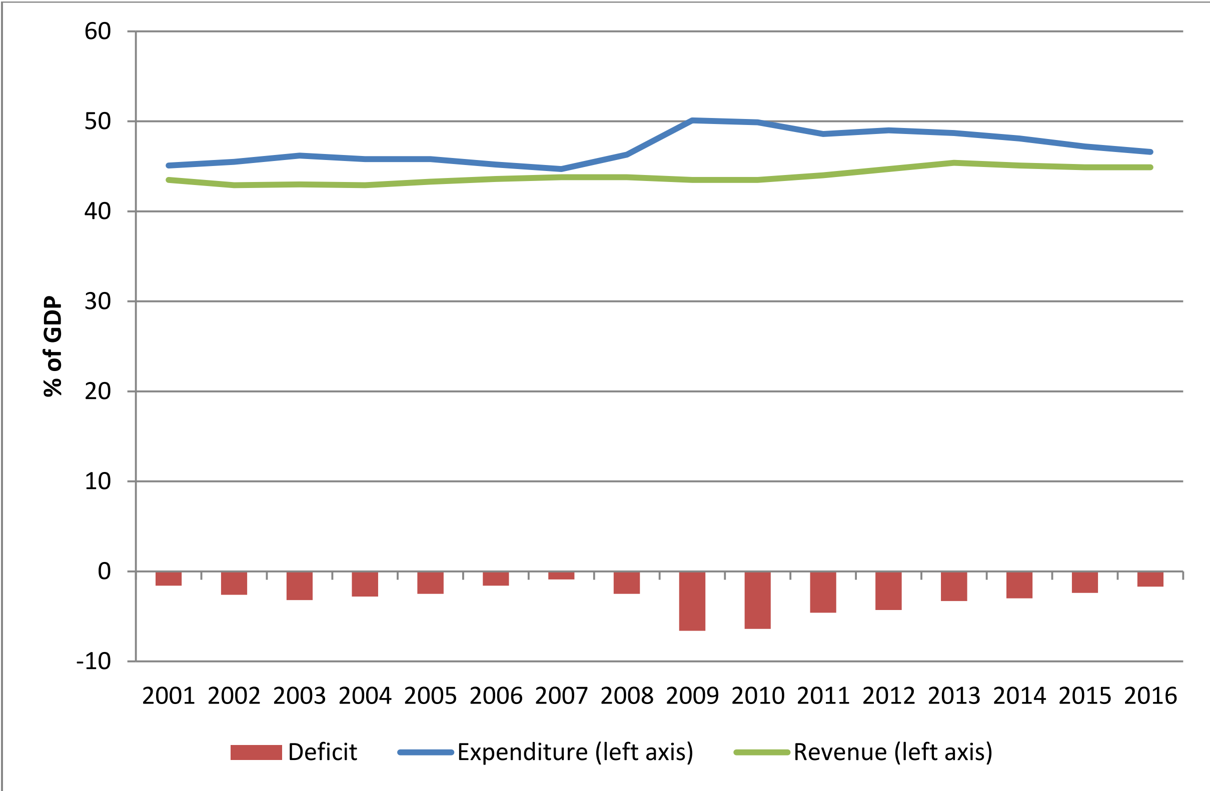
Figure 5-2- General government balance, 2009, 2013 and 2016



Source: Eurostat

[1] Automatic stabilisers are usually defined as those elements of fiscal policy which reduce tax burdens and increase public spending without discretionary government action (i.e. without changes in tax rates or allowances, benefit rates or expenditure programmes).

Figure 5-3- General government expenditure and revenue and general government balance, EU-28, 2001-2016



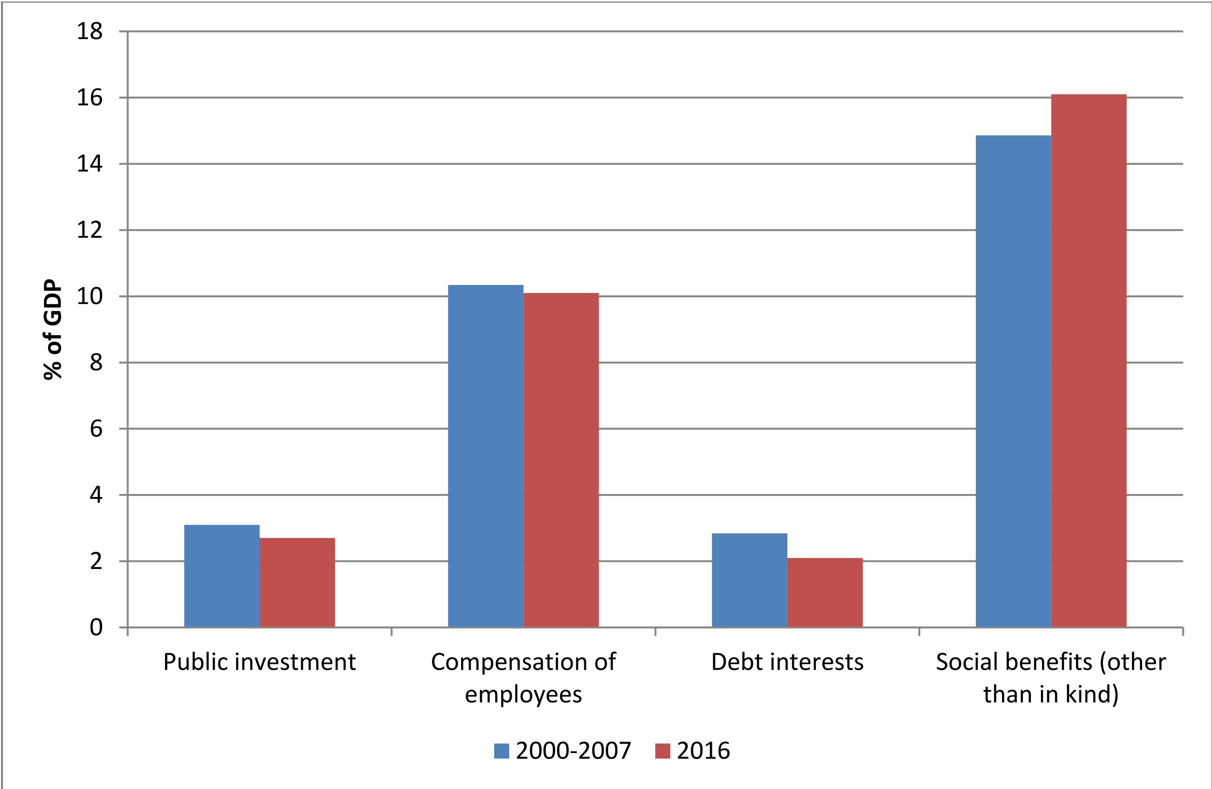
Source: Eurostat

5.1.2. The composition of public expenditure remains problematic, with government investment spending still low

After rising to an average of over 50% of GDP in the EU in 2009, government expenditure by 2016 had returned almost to the average level of 2000-2007 before the crisis (to 46.6% of GDP as against 45.5%).

However, the composition of public expenditure was different in 2016 to what it had been. Public investment (i.e. gross fixed capital formation) amounted to 2.7% of GDP as compared with 3.2% in the earlier pre-crisis period, half a percentage point less despite total public expenditure being higher (Figure 5-4). This contrasts with social expenditure which was over 1% of GDP higher.

Figure 5-4- Selected categories of general government expenditure, 2000-2007 and 2016



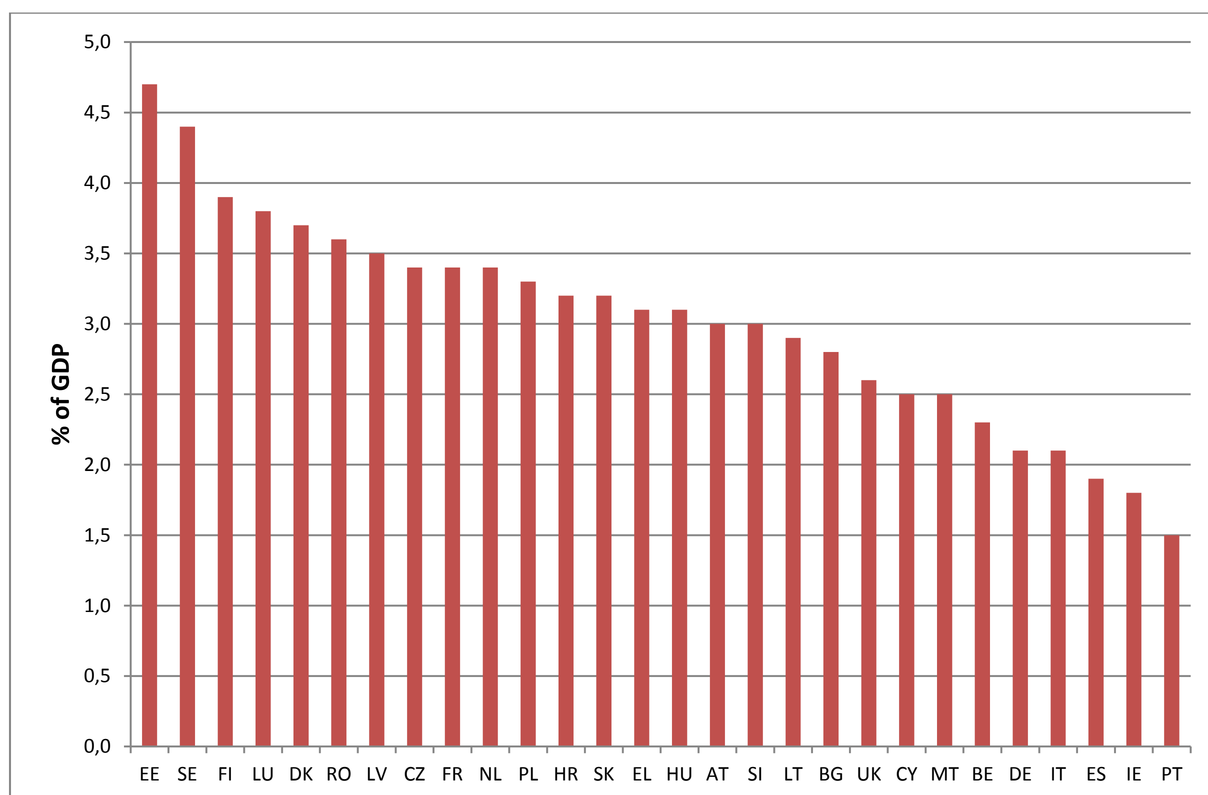
Source: Eurostat

The reduction in public investment is more striking in Member States hit hardest by the economic downturn. In a number of Member States subject to external financial assistance, public investment was below 2% of GDP in 2016 (in Ireland, Portugal and Spain) and though it was above 3% of GDP in Greece, GDP was much lower in 2016 than before the crisis. These low levels of public investment are to some extent a reflection of high levels of social expenditure, which were well above the EU average in Greece (20% of GDP) and Portugal (17%). The burden of servicing the debt is relevant too. Despite historically low levels of interest rates and the Quantitative Easing facilities provided by the European Central Bank, debt interest payments were still above 4% of GDP in Portugal and over 3% in Greece, which is an indicator of their vulnerability to changes in international financing conditions.

According to the economic literature, government investment has a positive effect on growth[2]. Persistent low levels of public investment are therefore a cause for concern, not least because of their possible effect on socio-economic disparities between Member States and regions in the EU. The Member States with the lowest levels of public investment are those hit hardest by the crisis and, accordingly, where disparities with the rest of the EU widened by most (Figure 5-5).

[2] See Sixth Report on Economic, social and territorial cohesion for a summary of the literature.

Figure 5-5- Total public investment, 2016



Source: Eurostat

The recent Commission reflection paper on the completion of the Economic and Monetary Union[3] emphasises that 'Progress on economic convergence is of particular relevance for the *functioning of the euro area but is equally important for the EU as a whole'* and that 'Moving towards high living standards and similar *ar income levels is key to achieving the Union's* objectives, which include economic and social cohesion alongside balanced growth'.

The low levels of public investment are also evident in the recent Commission Communication on the principle of additionality 2007-2013[4]. Seven Member States reported a level of expenditure relevant for additionality lower than forecast ex-ante at the beginning of the programming period 2007-2013 before the economic downturn. Actual structural spending for 2007-2013 was 35% lower than the ex-ante forecast in Greece, over 25% lower in Italy and between 10% and 20% lower in Hungary, Lithuania and Portugal[5].

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[3] European Commission. 'Reflection paper on the deepening of the economic and monetary union'. COM(2017) 291 of 31.5.2017.

[4] European Commission 'Ex-post verification of additionality 2007-2013.' COM(2017) 138 of 23.3.2017.

[5] It should be noted that since additionality was verified only in Convergence Objective regions, these figures do not necessarily depict the situation in the whole country except for Lithuania.

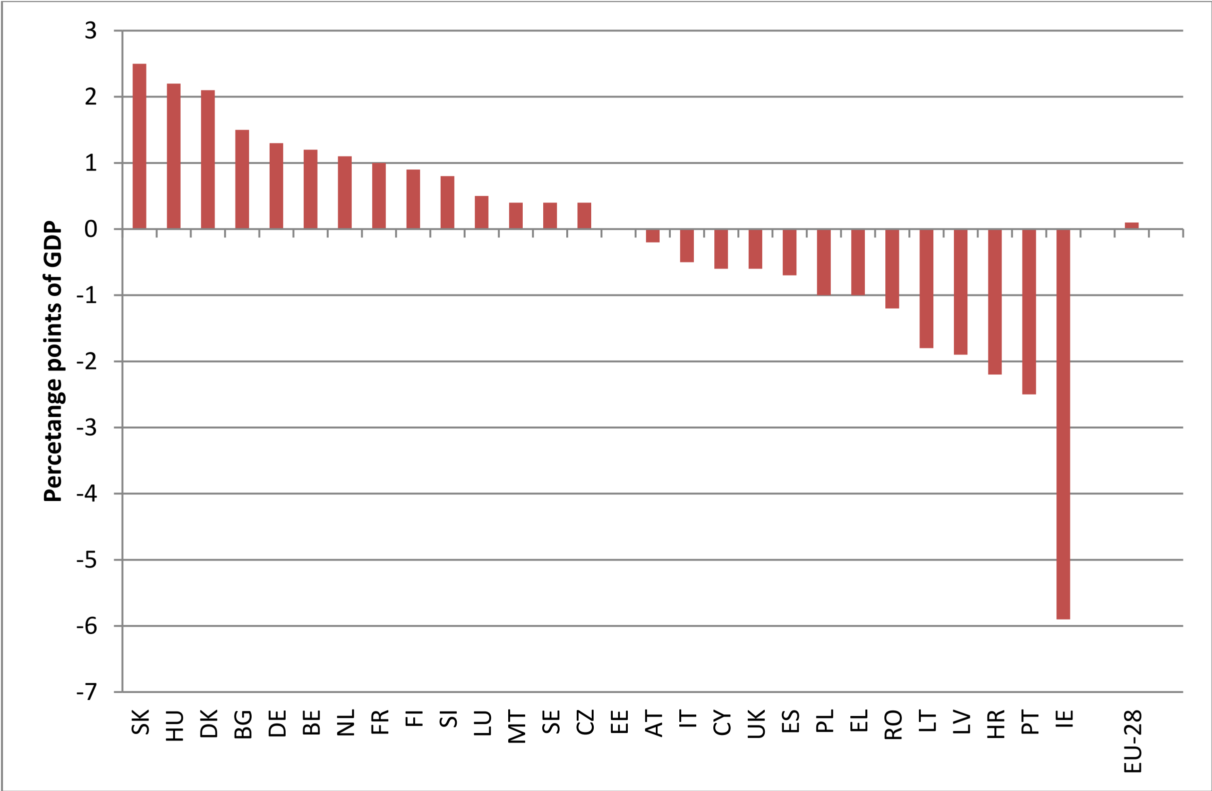
5.1.3. And growth-friendly expenditure has declined considerably in some Member States

In addition to gross fixed capital formation, which is the internationally recognised measure of public investment, other categories of public expenditure are also growth-friendly in that they help to create the conditions for higher future economic growth. These include, in particular, total expenditure on transport, communication, energy, research and innovation, environmental protection, education and health.

While growth-friendly government spending in the EU in 2015 was on average much the same as in 2008 relative to GDP, in a number of Member States, it diminished considerably (Figure 5-6). Most of these have a level of GDP per head below the EU average, which raises questions over the likelihood of the latter converging towards the EU average.

The reduction is particularly large in Ireland (a decline of close to 6% of GDP, spread across all categories), but also in Croatia (a decline of 2% of GDP, concentrated in transport) and Portugal (one of 2.5%, spread across all categories) which have experienced a protracted economic downturn.

Figure 5-6- Change in growth-friendly categories of general government expenditure, 2008-2015



Source: Eurostat

Over the EU as a whole, there was some shift over the period in the composition of growth-friendly government expenditure. A decline of 0.3% of GDP on expenditure on transport was accompanied by an increase of 0.5% of GDP on health, with all other categories of growth-friendly expenditure remaining much the same. The biggest decline in spending on transport was in Croatia (by 2.6% of GDP)[6], followed by Ireland (1.8%) and the Czech Republic (1.0%), In Latvia and Lithuania. Bulgaria, the Czech Republic and Netherlands, there was an increase in health expenditure (of around 1% of GDP), whereas in Greece and Ireland, it declined (by 2% of GDP). In other areas, there were significant cuts in spending on education in Ireland and Romania (of over 1% of GDP) and in the former, a reduction of over two-thirds in expenditure on environmental protection.

5.2. SUB-NATIONAL GOVERNMENTS PLAY A KEY ROLE IN PUBLIC EXPENDITURE AND INVESTMENT

5.2.1. Differences in the extent of decentralisation of public expenditure have widened in the EU…

Expenditure carried out by sub-national levels of government accounts on average for around a third of total public spending in the EU, and the share has not changed much over the past two decades despite the ups and downs in the total. The average, however, conceals significant differences across countries. In particular, the gap between more centralised and more decentralised Member States in the share of expenditure undertaken at the sub-national level widened markedly over the 15 years 2001-2016[7].

The Nordic countries, where powers are very much devolved to municipalities, and the Member States with federal or regional structures of government, which have the largest shares of public expenditure carried out at sub-national levels, all experienced further decentralisation of expenditure over this period (Figure 5-7). In Denmark, the most decentralised country in these terms, around two thirds of public expenditure was managed at sub-national level in 2016 and in Sweden, Belgium, Spain and Germany, around half.

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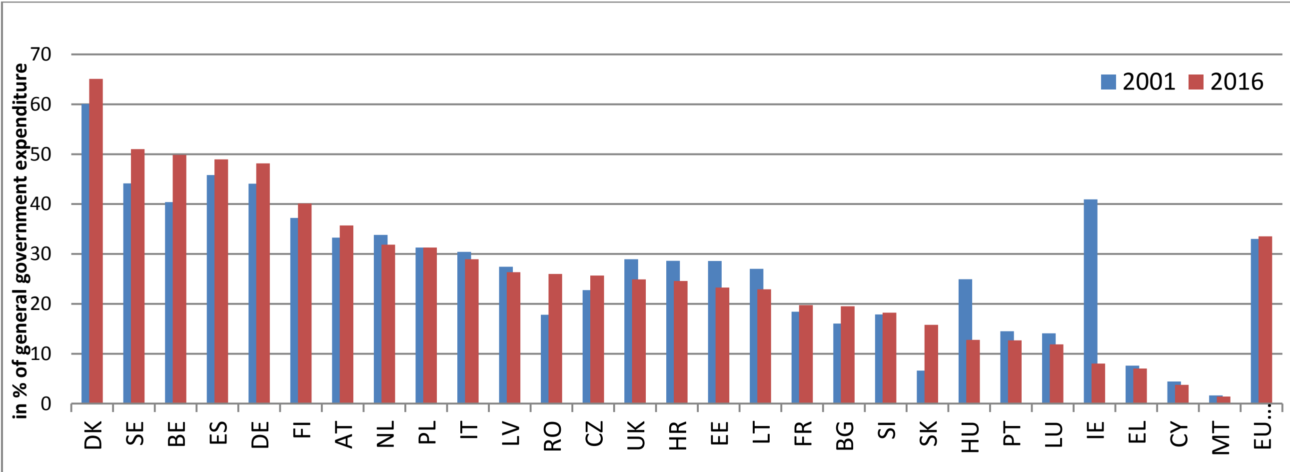
[6] The Croatian authorities cut on public investment to restrain the expenditure side. In the period before the crisis, this investment largely consisted of road (motorway) construction.

[7] Note that the fact that public expenditure is implemented at the regional or local level does not necessarily mean that decisions to spend are taken at the same level.

Figure 5-7- Sub-national government expenditure, 2001 and 2016

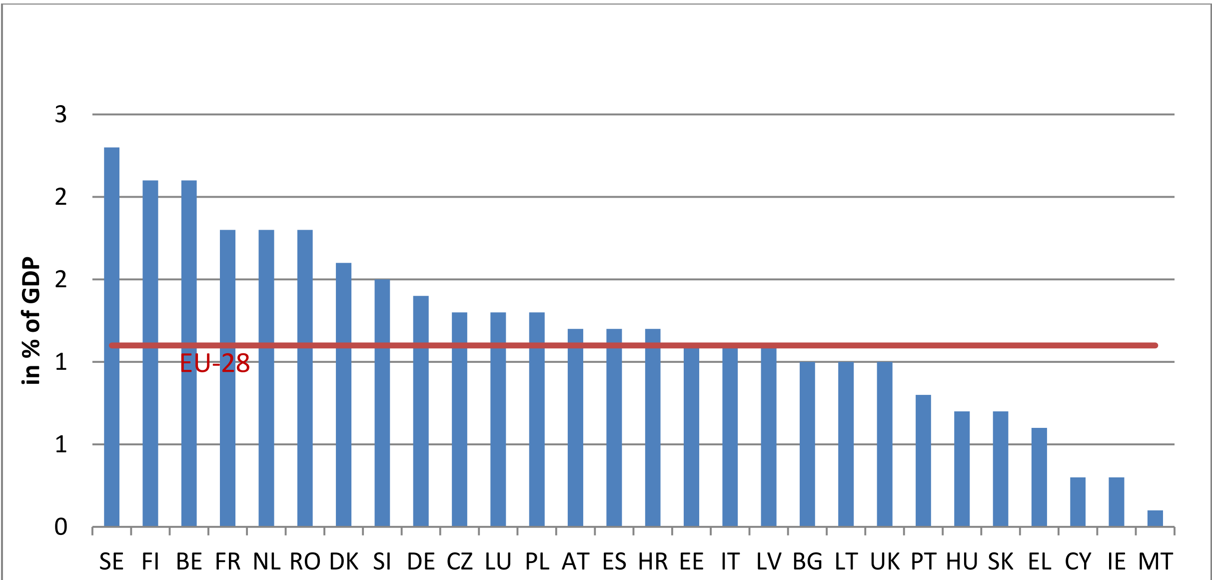


Source: Eurostat

At the same time, there is a tendency towards even further centralisation of expenditure in Member States where responsibility for public sending has traditionally been centralised. This is particularly the case in the Baltic States and, most especially, in Hungary, where the share of expenditure managed at the local level was reduced by half between 2001 and 2016. A similar tendency, though less marked, is also evident in Portugal, Greece and Italy. On the other hand, in Bulgaria, Romania and Slovakia, unlike in other EU-13 countries, the opposite tendency is evident.

Accordingly, in sum, differences in the extent of decentralisation of public expenditure have tended to widen across the EU in recent years, with spending becoming more decentralised in the Nordic countries, the federal States and a few EU-13 Member States and more centralised in most EU-13 countries and, to a lesser extent, in southern Member States, apart from Spain.

Figure 5-8- Sub-national government investment, 2016



5.2.2. …while public investment is now slightly more centralised

Unlike total public expenditure, the management of public investment is becoming increasingly more centralised in the EU, the share managed by sub-national governments declining from over 60% of the total in the mid-1990s to 56% in 2001 and 52% in 2016.

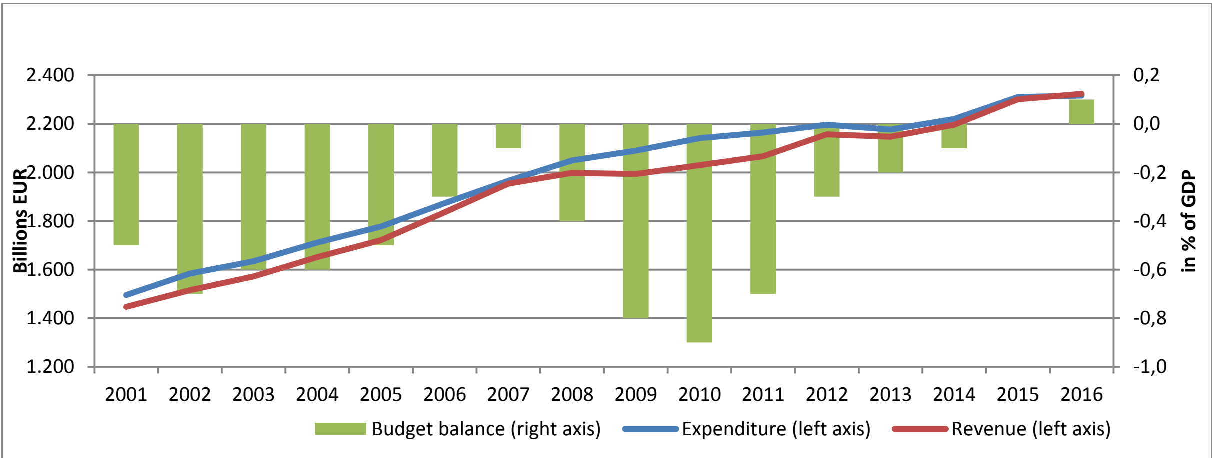
The difference in tendency compared to total public expenditure is mostly a result of trends in Member States with a federal or regional structure of government, except Belgium (i.e. Germany, Austria and Spain), in all of which the share of public investment managed by sub-national governments declined between 2001 and 2016 whereas their share of total spending increased.

In the rest of the EU, changes in the share of public investment managed at sub-national level are very much in line with those for total public expenditure. In the Baltic States and Hungary, therefore, there was a significant decline in the share, as there was in Poland. By contrast, the share of sub-national governments more than doubled in Bulgaria and Romania between 2001 and 2016.

5.2.3. The budget balance of sub-national governments is now in surplus

Unlike in each of the previous 15 years, the budget balance of sub-national governments in the EU was, on average, in surplus in 2016, the culmination of a steady reduction in deficits, which reached a maximum of 0.9% of GDP in 2010 (Figure 5-9). The gradual improvement in their budget balance occurred in parallel with that of public finances as a whole. In 2002, sub-national governments were responsible for around a quarter of the general government deficit and their share declined to 15% in 2011 before the balance going into small surplus in 2016 (of 0.1% of GDP). The reduction in the deficit of sub-national governments occurred at the same time as their share of total public expenditure remained unchanged at around a third.

Figure 5-9- Sub-national government expenditure, revenue and budget balance, EU-28, 2001-2016

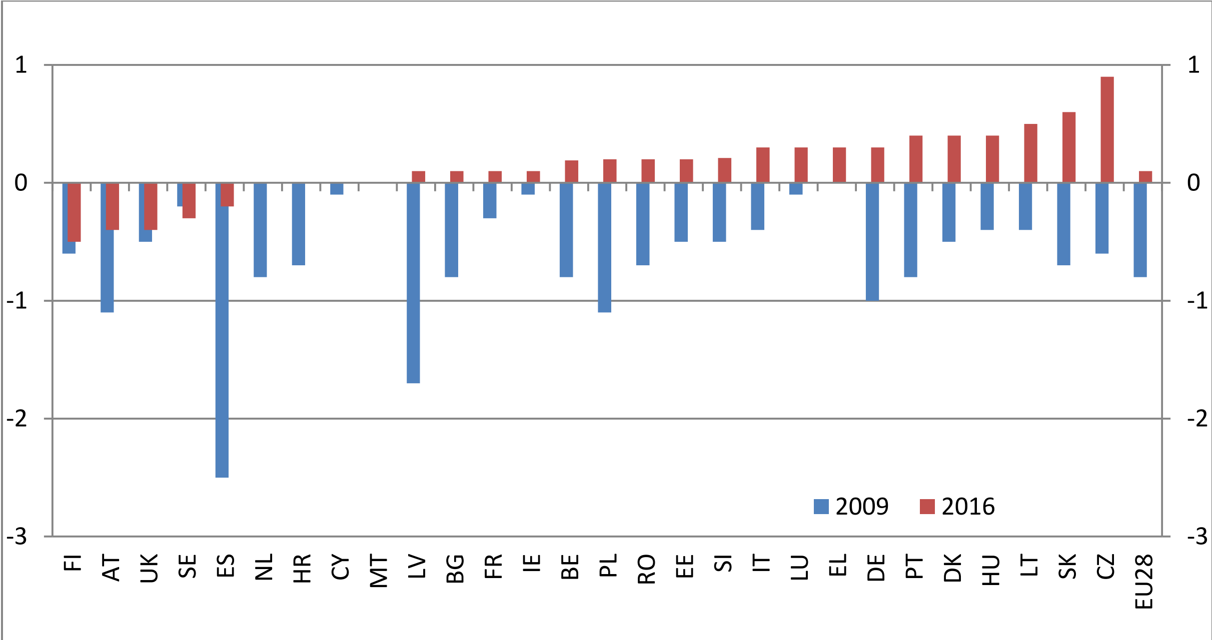


Source: Eurostat

Again, the average tendency conceals differences between Member States, though there was a common improvement in public finances at sub-national level in all of them except Sweden (Figure 5-10). Their budget was a surplus in 19 Member States in 2016, in balance in four and in deficit, though by a modest amount, in only 5.

The gradual reduction of the sub-national deficits results to some extent from the fact that public expenditure witnessed a trend over centralization more intense than revenues. That is, the trend in sub-national deficits is linked to the trend towards centralisation of public expenditure.

Figure 5-10- Sub-national governments budgetary balance, 2009 and 2016



Source: Eurostat

5.3. REVIEWING HOW THE ESI FUNDS ARE LINKED TO NEW COUNTRY-SPECIFIC RECOMMENDATIONS AND TO SOUND ECONOMIC GOVERNANCE

5.3.1. Introduction

Article 23(16) of Regulation (EU) N° 1303/2013 (the "Common Provisions Regulation" or "CPR") requires the Commission to carry out a review of the application of Article 23 in 2017. This review is to be in the form of a report to the European Parliament and the Council, accompanied where necessary by a legislative proposal modifying the Article. The present report fulfils this requirement.

The legal framework of the European Structural and Investment Funds (hereafter the 'ESI Funds') for 2014-2020 introduced a number of new provisions which strengthened the linkages between the ESI Funds and sound economic governance, with the aim of improving the overall performance focus of ESI programmes.

Under paragraphs (1) to (8) of Article 23, the Commission may request a Member State to review its Partnership Agreement and relevant programmes to (i) support the implementation of relevant country specific recommendations (CSRs) adopted in the context of the general economic policy or employment guidelines (Articles 121 (2) and 148 (4) of the Treaty on the Functioning of the European Union (TFEU)), (ii) other Council recommendations adopted in the context of Regulation (EU) N° 1176/2011 on the prevention and correction of macroeconomic imbalances or (iii) to maximise the growth and competitiveness of Member States under Union financial assistance. In the event of non-effective action by the Member State, the Commission may propose to the Council to suspend all or part of the ESI payments to the Member State concerned, after having set out the grounds for concluding that the Member State has failed to take effective action.

Under paragraphs (9) to (12) of Article 23, the Commission will propose to the Council the suspension of all or part of the commitments or payments, if the Council decides that a Member State has not taken effective action to correct its excessive deficit in accordance with paragraphs 8 and 11 of Article 126 TFEU or in two successive cases of not addressing excessive macroeconomic imbalances in the same imbalance procedure in accordance with Regulation (EU) N° 1176/2011. The Commission will also propose such a suspension in cases where a Member State has not taken measures to implement an economic adjustment programme.

5.3.2. New country-specific recommendations linked to the ESI Funds

Regarding the provisions under paragraphs (1) to (8) relating to the power of the Commission to request the Member State to review its Partnership Agreement and relevant programmes, it is important to recall that Article 15 of the CPR requires Partnership Agreements to take account of the relevant CSRs adopted in accordance with Articles 121 (2) and 148 (4) TFEU. That is, all relevant CSRs adopted by the Council before the adoption of the Partnership Agreements and programmes had to be properly and sufficiently addressed by the Partnership Agreements and programmes adopted in all Member States.

Indeed, more than two-thirds of the CSRs adopted in 2014 were considered relevant for the ESI Funds and have been taken into account in Member States' Partnership Agreements and programmes[8]. They cover reforms in seven main areas: research and innovation, energy and transport, health care, labour market participation, education, social inclusion and reform of the public administration[9].

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[8] European Commission 'Investing in jobs and growth - maximising the contribution of European Structural and Investment Funds.' COM(2015) 639 of 14.12.2015.

[9] European Commission 'European Structural and Investment Funds 2014-2020, 2016 Summary Report of the programme annual implementation reports covering implementation in 2014-2015.' COM (2016) 812 of 20 December 2016.

The relatively late adoption of the 2014-2020 programmes, combined with the ensuing delays in starting their implementation and the recent streamlining of the CSRs has, to some extent, curbed the possible launch of any reprogramming request by the Commission. It is important to recall that indent (a) of paragraph (1) of Article 23 refers to 'relevant' Council recommendations, whose definition is provided in paragraph (35) of Article 2. This legal provision provides that, for the purposes of a possible reprogramming request by the Commission, 'relevant Council recommendation' means a 'recommendation relating to structural challenges which it is appropriate to address through multiannual investments that fall directly within the scope of the ESI Funds as set out in the Fund-specific Regulations'. That is, the link refers only to CSRs relating to investment, so excluding those whose implementation depends on legislative and/or administrative legal changes or reforms. Therefore, the link between any reprogramming request and a relevant CSR must be indisputable, which is less likely with the new streamlined approach with fewer and more general CSRs. In addition, the nature and content of the CSRs since 2014 has been relatively stable, meaning that Partnership Agreements and programmes are still to a large extent aligned with the relevant CSRs that were adopted as of 2015.

In this context, the Commission has not found any reason to launch a request for a review of Partnership Agreements or programmes in any Member State. In its Communication of 2014 providing guidelines on the application of the measures of paragraphs (1) to (6)[10], the Commission stated that 'the reprogramming powers granted to the Commission would be used carefully [and that] stability [would] be preferred over too frequent reprogramming'. This Communication also emphasised that 'the priority in the Partnership Agreements and programmes [would] be to adequately address the challenges identified in the CSRs and relevant Council recommendations' and that it would 'limit possible reprogramming under Article 23 in the short term'. This has been the case.

That Communication was following up on the commitment given by the Commission. In particular, it clarified the notion of 'review' and the types of 'amendments' to Partnership Agreements and programmes and an indication of the circumstances which may give rise to a suspension of payments.

5.3.3. Sound economic governance and the ESI Funds

As regards the provisions of paragraphs (9) to (12), the Commission will propose to the Council the suspension of funding in case of non-effective action by the Member States under one of the economic governance surveillance procedures or under an economic adjustment programme. The only scenarios in which the conditions for the application of these provisions could have been fulfilled were the Council Decisions of July 2016 referring to non-effective action by Spain and Portugal to address their respective excessive deficits.

More specifically, on 12 July 2016, the Council concluded that the response by Spain and Portugal to the recommendations adopted according to Article 126(7) TFEU had been insufficient. The Council therefore established that there had been no effective action in

[10] European Commission 'Guidelines on the application of the measures linking effectiveness of the European Structural and Investment Funds to sound economic governance according to Article 23 of Regulation (EU) 1303/2013' COM(2014) 494 of 30.7.2014.

response to its recommendations within the period laid down according to Article 126(8) TFEU.

As required by paragraph 9, the Commission immediately informed the Parliament by letter of 14 July 2016 from Vice-President Katainen, to the President of the European Parliament. In the letter, the Commission explained that the conditions to make a proposal to suspend funding were fulfilled and that the Commission remained at the disposal of the European Parliament to participate in a structured dialogue. This structured dialogue is envisaged by paragraph 15 of Article 23, which provides that 'The European Parliament may invite the Commission for a structured dialogue on the application of this Article'.

On 25 July, the President of the European Parliament replied through a letter addressed to President Juncker, which expressed his intention to invite the Commission to a structured dialogue 'at the earliest opportunity after the summer recess'. Paragraph 9 provides that, when making its proposal, the Commission 'shall give due consideration to any elements arising from and opinions expressed through the str*uctured dialogue under paragraph 15'.* That is, the Commission had to take account of the results of the structured dialogue with the Parliament.

On 26 September, the President of the Parliament confirmed the invitation to a structured dialogue in another letter addressed to the President of the Commission. The structured dialogue started on 3 October 2016 in Strasbourg in a session involving Vice-President Katainen and Commissioner Creţu, with members of the committees of Regional Development and of Monetary and Economic Affairs of the Parliament.

After that session, the Parliament expressed some days later its will to continue the structured dialogue and to hear the views of the representatives of the governments of the two Member States concerned.

On the basis of the reports on action taken to address their excessive deficits submitted by Spain and Portugal, the Commission decided on 16 November 2016 that their respective Excessive Deficit Procedures should be held in abeyance. Paragraph 12 establishes that 'the Commission shall lift the suspension of commitments, without delay, where the excessive deficit procedure is held in abeyance in accordance with Article 9 of Council Regulation (EC) No 1467/97'. That is, the conditions to lift the suspension of funding were met before the structured dialogue with the Parliament was finalised.

5.3.4. At this stage legislative changes are not required

Article 23 introduced a number of strengthened linkages between the ESI Funds and sound economic governance. This Article ensures consistency between the implementation of the ESI Funds and the economic policy agenda of the EU across the whole programming period. The Commission considers there has been no need to trigger the application of this Article during the first half of the current programming period.

The Partnership Agreements and programmes financed by the ESI Funds are still aligned with the latest relevant CSRs adopted by the Council. There was no fundamental change since the adoption of the Partnership Agreements and programmes to justify any request for review. The Commission expressed already in 2014, at the beginning of the programming period, that

such a request would be launched only in cases where it could have a better impact to address structural challenges and that stability would be preferred over frequent reprogramming. While the consistency between programmes and economic policy recommendations is essential, the Commission also attaches major importance to the stability and predictability of the programmes financed by the ESI Funds.

As regards the provisions linking the ESI Funds with the economic governance surveillance procedures, the Commission considers they have helped to provide important incentives to the Member States concerned to take effective action in a reasonable time to correct and put an end to their excessive deficits. This legal framework has also enabled constructive and loyal cooperation between the institutions of the EU in ensuring an efficient and balanced implementation of these provisions. While there is no specific deadline for the completion of the structured dialogue, it is important that it is concluded in a reasonable timeframe during which the necessary incentives to take effective action are provided to the Member State concerned.

While bearing in mind that stability and predictability are important conditions for an effective implementation of the ESI Funds, the Commission will not hesitate to apply and implement the provisions of this Article when deemed necessary or when one of the milestones envisaged as triggering points is reached.

On this basis, the Commission considers there is no need to make any proposal to the Council and the Parliament to modify this Article at this stage.

5.4. CONCLUSIONS

Public investment remains at historically low levels (as a share of the GDP) in the EU. This is a result a decline in public expenditure since 2010, coupled with the share of public investment in the total being reduced, to some extent because of higher levels of social spending and debt interest.

This is a cause for some concern because of the importance of investment in fueling and underpinning growth. Private investment is beginning to recover after a number of years of substantial decline and public investment has a major role to play in helping to restore the conditions which encourage enterprises to invest.

The share of public investment co-financed by EU cohesion policy increased considerably during the crisis period as national and regional government spending declined. In many countries, it played a major counter-cyclical role in stabilising public investment, accounting for half or more of the total that took place in many EU-13 countries. In that context, the total investment package under the European Cohesion policy shrank in some Member States as a result of the downward revision of the national co-financing rates. These decisions were adopted to take account of the temporary difficulties in national and sub-national budgets and pressure over public finances.

The management of public investment across the EU has become more centralised over recent years. The share managed by sub-national governments is now close to 50% whereas it was over 60% two decades ago. Since the composition of investment did not change significantly,

this seems to be a result of political decisions to shift responsibility for investment more to central government.

The budget balance of sub-national governments has been transformed from a deficit of close to 1% of GDP in 2010 to a surplus, so that the overall general government deficit in 2016, which averaged just under 2% of GDP, was solely accounted for by central government and the Social Security funds.