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Book Review

Public investment, growth and fiscal constraints: Challenges for the EU New Member States

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reviewed by Stilianos Fountas*

This book consists of an introduction by the editor Massimo Florio and nine papers presented at the Milan European Economy Workshop 2009. The primary objective of the book is to focus on the importance of public investment for growth in the presence of fiscal disequilibria expressed in large fiscal deficits and rising public debt. The book focuses on a very timely topic, given the low-growth prospects and fiscal policy constraints facing the current and prospective Eurozone member countries. The book is divided in three parts, each part consisting of three chapters.

The first part looks at the contribution of public investment to growth from both a theoretical and empirical point of view. In the first chapter Malcolm Sawyer presents two macroeconomic approaches to fiscal deficits and discuses their relative merits. These approaches are the "fiscal consolidation and Ricardian equivalence" approach and the "functional finance" approach. The first approach predicts that a change in the fiscal deficit has no impact on aggregate demand since the private sector responds in a manner that offsets any aggregate demand effects. It is also possible that a fiscal contraction may have expansionary effects if it affects the private sector's expectations about future tax policy, thus leading to higher permanent income and consumption. The functional finance approach suggests a fiscal rule not based on a balanced budget: rather it guides the size of the deficit according to the highest level of sustainable output. The author argues against the Stability and Growth Pact on the basis that it imposes fiscal limits at each point of the business cycle.

In the second chapter, Chiare del Bo provides a survey of the effects of public investment, public capital and fiscal policy on growth from a theoretical and (mostly) empirical point of view. In the first part, the author surveys the theoretical and empirical literature and concludes that productive capital spending enhances growth. In the second part, the literature surveyed indicates that fiscal rules contribute to economic growth, but fiscal consolidation should not be accompanied by cuts

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in productive investment which are detrimental to growth. In the third chapter, Massimo Cingolani provides an analysis of public investment in a disequilibrium framework characterized by unemployment and suboptimal production. The theoretical apparatus employed is the model of the monetary circuit placed in a post Keynesian perspective. In a disequilibrium setting, the role of public investment in tackling underemployment becomes very critical and it is quite different from that in a neoclassical setting. In the circuit model, new money creation is an instrument for anchoring diverging private expectations and stabilizing the economy. The model presented in the chapter has important implications for the coordination of European fiscal policies in the form of collective management of public investment.

In the second part, three chapters analyze the relationship between the fiscal framework and the size of public investment in the EU-15 (the original members of the EU) and the New Member States (NMS). In the first chapter, Ángel Catalina Rubianes looks at differences in public expenditure and public investment across old and new EU member states. Despite a large public sector in the EU-15, public investment has been higher in the NMS during the last decade in comparison with the EU-15. In their attempt to satisfy budgetary restrictions, NMS cut public expenditure without losing out in terms of productive expenditure (i.e., public investment). This may explain why NMS managed to catch up with the EU average in per capita GDP. The second part of the chapter focuses on the comparison of public expenditure in the EU. It is shown that investment in physical capital increased at the expense of public spending in social protection and human capital. In the last part of this chapter, the author tries to determine the impact of the recent crisis on public investment in the NMS. It is shown that the deterioration of public finances had an adverse impact on public investment mostly in countries with levels of debt and low rates of public investment. In some NMS though (Bulgaria, Cyprus, Czech Republic), the effect of the crisis on public investment had been positive.

In the next chapter, Giuseppe Bognetti and Giorgio Ragazzi provide an evaluation of the economic performance of six NMS in light of the requirement of convergence criteria for joining the Eurozone. It is shown that, with the exception of Hungary, these countries have met the fiscal criteria. The stability of their exchange rate hinges on international capital flows and external demand. In the sixth chapter, Jan Hanousek and Evžen Kočenda examine in detail the macroeconomic situation in each of the NMS that have joined the EU since 2004. The emphasis is on the fiscal policy front and in particular on the trends in public investment in different sectors of economic activity. All these twelve countries enjoyed an increase in the volume of public investment, both in absolute terms and as a GDP share. The greatest benefits took place in transport systems, general government services, housing and education. The financial crisis of 2008 has had an adverse impact on all NMS due to falling export demand and capital flows. The chapter concludes that it is important to maintain financial stability and apply rational fiscal policies in order to facilitate the convergence process of the NMS that was hampered by the crisis.

The third part of the book looks at public investment at the industry and regional level. EU regional and industrial policies are critical in shaping the growth prospects of EU countries. In the seventh chapter, Aleksandra Parteka analyses labour productivity changes caused by inter- and intra-industry structural change in the NMS that joined the EU in 2004. The author concludes that productivity growth in the 1995-2005 period was due mostly to increasing productivity within sectors rather than labour reallocation across sectors. Productivity growth was due mostly to trade openness and in particular increasing trade with the EU-15. An additional determinant of productivity growth is government spending on education, public order, safety, and social protection. In the next chapter, Luigi Moretti studies the importance of the Structural and Cohesion Funds (SCF) business support for manufacturing performance (employment growth) in a sample of regions located in the Central and Eastern Europe NMS that joined the EU in 2004. Via sensitivity analysis, the author finds the list of regions, countries and industries that would get the most benefit from higher expenditure on SCF business support. In the final chapter, Emanuela Sirtori and Silvia Vignetti present a descriptive study of infrastructure gaps in the EU member states at the national and regional level for four infrastructure sectors: transport, telecommunications, environment, and energy. The major findings are (i) significant gaps exist between the EU-member states and (ii) regional gaps found in the NMS are not wider than those in some EU-15 countries.

In summary, this book is a very well written volume and a timely piece published at a time when European countries and, in particular, member-countries of the Eurozone are facing severe fiscal disequilibria and very low output growth rates. Given the constraints placed on monetary policy by the common currency and the loss of monetary policy autonomy, the role of fiscal policy and, in particular, public investment in a setting of fiscal constraints and low-growth rates becomes critical. The material included in the book will be very useful to academics, researchers and practitioners of issues addressed in the various chapters.