Increasing public investment to strengthen the recovery from the pandemic: A glass only half-full

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As the recovery from the pandemic progresses, there is an opportunity to refocus fiscal policy support and shift the composition of government expenditure towards productive investments in physical infrastructure, education and research. Provided they are well designed and managed, such investments can strengthen growth prospects and have a durable impact on living standards (Fournier, 2016; Pain et al., 2018).

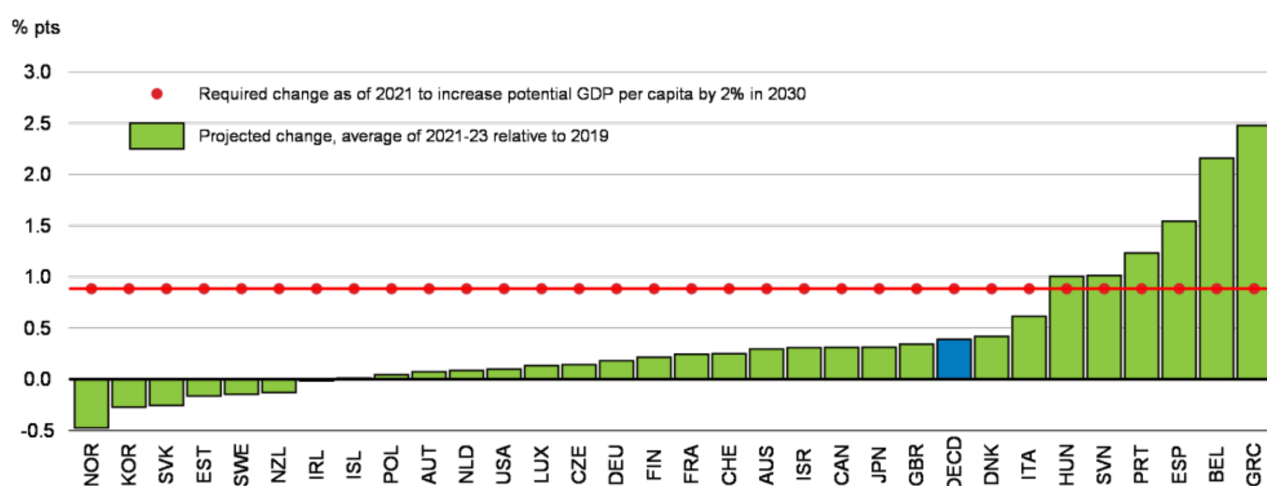
Additional public investment and research is needed to help foster the transition to a low-carbon economy, strengthen the digital transition, and enhance incentives for private investment. In many countries, there is also a need to enhance spending on the maintenance, repair and modernisation of existing infrastructure after an extended period when investment was barely enough to make up for infrastructure depreciation. Following the global financial crisis, many countries disproportionately cut public investment in a context of sharp fiscal consolidation, slowing the recovery and leaving scars for the future (OECD, 2016).

Fortunately, the policy response to the COVID-19 pandemic appears to be so far more favourable. Public investment, which understandably was not the key priority when the pandemic struck, is expected to increase in 2021-23 relative to 2019 levels in about 80% of OECD member countries, by 0.4% of

potential GDP on average (Figure 1).[1] The share of investment in (cyclically-adjusted) total public expenditure is also expected to increase in about three-fifths of OECD economies, and rise from 8.8% in 2019 to an average 9.3% in 2021-23 in the 33 OECD countries with available data.

Figure 1. Projected public investment increases are welcome but often too modest

Changes in the average annual public investment-to-potential GDP ratio



Note: Red markers show the increase in the average annual public investment-to-potential GDP ratio over 2021-30 that is required to boost potential GDP per capita by 2% in 2030. The growth effects of spending reallocation towards public investment are estimated keeping government size unchanged, and thus imply proportional decreases in spending on other budget items, whose growth effects, positive or negative, are controlled for. "OECD" shows the unweighted average of countries included in the figure.
Source: OECD Economic Outlook 110 database; Fournier and Johansson, 2016; Cournède et al., 2018; and OECD calculations.
Is this ambitious enough? Past OECD research quantifies the impact on potential growth of shifting the composition of public expenditure towards public investment while keeping total spending unchanged (Fournier and Johansson, 2016; Cournède et al., 2018). These estimates can be used to compute

how much spending reallocation towards public investment would be needed to increase potential GDP per capita by a certain amount in the medium and long run. For instance, a rise of close to 1 percentage point in the average annual public investment-to-potential GDP ratio over 2021-30 would yield a 2% increase in potential GDP per capita by 2030, corresponding to an acceleration of approximately 0.2 percentage points in the annual growth of potential GDP per capita in the coming decade.

This would be a sizeable gain, but still only a partial compensation for past losses. Annual potential GDP per capita growth stood at a modest 1.1% in the median OECD country over 2010-19, about 0.9 percentage points lower than in the decade before the global financial crisis. Even so, most countries are projected to fall short of the required public investment threshold over 2021-23 in the December 2021 OECD Economic Outlook (Figure 1). However, it is not too late for countries to catch up: ramping up investment later in this decade could also yield the same 2% gain in potential GDP per capita, even if with some delay relative to 2030.

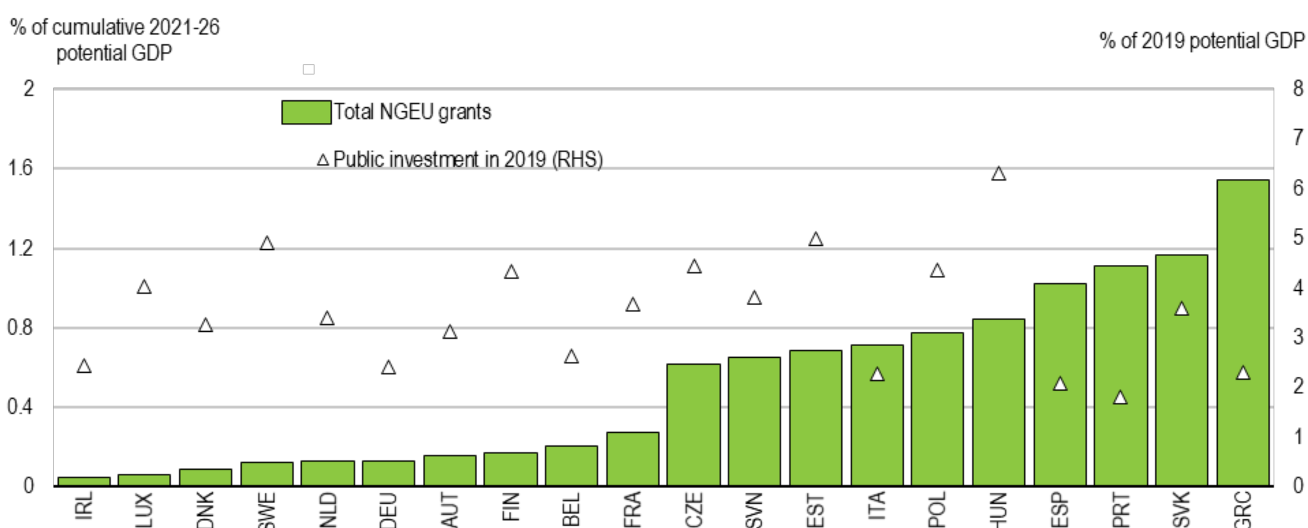
The required improvement in public investment over the current decade is based on highly stylised estimates that reflect average effects across countries. These abstract from country-specific features, such as differences in administrative capacity for carrying out investment projects efficiently or potential diminishing returns to further new investment when public capital stocks are already very high.[2] Nonetheless, the results point to a need for larger annual public investment increases over the next decade than those currently envisaged until 2023.

Next Generation EU (NGEU), the European recovery package, is expected to make a difference in the EU member states. The countries with the most ambitious projected increases in public investment over 2021-23 tend to be among the largest

estimated recipients of NGEU grants relative to GDP, notably Greece, Portugal and Spain (Figure 2). Another major recipient, Italy is also projected to raise investment substantially in the coming years, but more gradually.[3] In all four cases, pre-pandemic public investment-to-potential GDP ratios were very low (Figure 2). Some countries with relatively high public investment prior to the pandemic and sizeable estimated NGEU support are also projected to increase investment swiftly, such as Hungary and Slovenia. In contrast, others are projected to do it more slowly, such as Poland. Whether implementation strategies are more or less frontloaded, NGEU can ensure substantial support to public investment across the EU until 2026 (when projects should be completed) provided NGEU grants add to, rather than replace, national funding.

Policy mistakes made in the past decade are not being repeated, but stronger increases in public investment are called for in many countries. It would be a pity to leave the glass only half-full.

Figure 2. NGEU can provide substantial support to public investment in Southern and Eastern EU countries



Note: The illustrative estimates include the following NGEU components: Recovery and Resilience Facility (RRF), REACT-EU, Just Transition Fund and European Agricultural Fund for Rural

Development. Part of RRF allocations will be revised by June 2022. Potential GDP estimates assume that annual potential output growth over 2024-26 will be unchanged from that projected for 2023. The period 2021-26 broadly corresponds to the implementation of NGEU. Grants can also be used to finance government expenditure other than public investment, such as government capital transfers to support private investment.
Source: European Commission, Directorate-General for Budget (2021), *The EU's 2021-2027 long-term budget & NextGenerationEU: Facts and Figures*; European Commission, European Structural and Investment Funds database; OECD Economic Outlook 110 database; and OECD calculations.

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[1] Measuring public investment as a ratio to *potential* GDP, rather than actual GDP, is useful to focus on long-term structural effects and ensures that the ratio is not distorted by short-run fluctuations in output, which have been particularly sharp in the pandemic period.

[2] Diminishing returns would be more likely for new investment in the type of projects often carried out in the past (e.g. new motorways or airports in a country where they are already abundant), as opposed to public investment in new or still underdeveloped areas (e.g. smart grids or fast-charging infrastructure for electric vehicles).

[3] Nonetheless, by 2023, the Italian public investment-to-potential GDP ratio is expected to be 0.9 percentage point higher than in 2019.