
What role for social investment in the new economic governance of the Eurozone?

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BACKGROUND

The EU, and in particular the Eurozone, has been suffering through a period of prolonged economic difficulty, in particular the countries most affected by the euro crisis. While there are some signs of recovery, growth rates remain too low, in line with low growth rates in the pre-crisis period. This not only affects the creation of jobs, with unemployment rates remaining far too high in many countries, but also – through lower tax revenues and stagnant GDP levels – the consolidation of public finances.

Investing in the future?

Not only is current growth too low, Europe is also not investing enough in its future productive capacity, which will influence long-term growth rates. According to Eurostat, since its peak in 2007, total (business) investment as a ratio of GDP has decreased from 23.4% to only 19.8% in 2014. In order to revive growth and investment, the EU has set up an investment plan for Europe, also known as the Juncker plan. With the creation of the new European Fund for Strategic Investment (EFSI), the European Commission expects to generate EUR 75 billion for SME funding and EUR 240 billion for long-term investment over the next three years (2015-2017), using limited public funding to leverage private investment.

Private investment is crucial to revive lacklustre growth in Europe but questions remain around how well the Juncker plan is going to perform, including: whether a leverage ratio of 1:15 can be achieved; how fast the plan will be up and running; how much of the investment will reach beyond traditional infrastructure and support to SMEs; and whether it will be beneficial to all parts of Europe. But even if the plan turns out to be less effective than originally envisaged, it can still make a positive contribution to growth.

What role for public investment?

Regardless of the Juncker plan's success, other efforts to stimulate long-term growth potential are necessary as well. Here, member state public investment also needs to play a role. If spent productively, the public sector can provide the right infrastructure and networks, equip the workforce with the right skills and provide the enabling environment for all parts of the workforce to get into employment. Such public investments can even have a short-term impact on growth when activating idle resources and workforces – in the construction sector, for example.

But in an environment of fiscal consolidation – with fiscal limits enshrined in the new economic governance mechanisms – all public spending is constrained, including public investments, which tend to be an easy candidate for budget cuts as they are not defended by any particularly strong interest group. According to Eurostat, government investment in the euro area has declined substantially with its ratio to GDP falling from 3.6% in 2009 to only 2.7% in 2014. Cutting public investment has been a common response of European governments during the crisis, despite various studies highlighting the detrimental effects on growth. Cournède et al. (2014)¹ show that attempting fiscal consolidation through reductions in public investment is far from optimal: out of 17 categories, only cutting spending on

health services in kind; social security contributions; childcare and family; and education are more harmful to economic growth than reducing public investment. Instead the authors suggest that better options for reviving growth are cutting subsidies and pensions or imposing higher property taxation.

Social investment as a driver for growth

But it is not only traditional public investment focused on infrastructure that suffers in an economic crisis. Social investments – childcare, health and education – are equally affected. The European Commission defines social investment as "strengthening people's current and future capacities", which "[...] have lasting impacts by offering economic and social returns over time, notably in terms of employment prospects or labour incomes."² Investing in these policy areas can thus have a significant economic impact. A well-known example is investment in the quality and availability of child care. Not only will better access to quality child care improve early year education but it can also improve female participation in the labour market, which could counter Europe's shrinking workforce that reduces growth prospects as well as tax revenues. This investment logic applies to many areas of social spending, including the investments that need to be made to integrate the arriving refugees in Europe's labour markets, which will produce long-term returns if successful.

Beyond growth?

Social investment in childcare, education and other human capital-focused policy areas is also a way to reduce income inequality, and as such bears direct relevance to the debate on how inequality effects economic growth, in which some argue that more equal societies also have a better growth performance. While there are indeed indications that inequality might harm growth³, this is far from conclusive: for example, Paul Krugman considers the methodology of mostly using growth regressions problematic for identifying causations between inequality and growth⁴, despite being a strong advocate for reducing inequality for social and political reasons.

But even if there is no direct link to growth, there is certainly no indication that high inequality is beneficial for growth. Even without a link between inequality and growth, there is a strong case for policy makers to tackle high levels of inequality through either redistribution or social investment. The purpose of social investment is clearly not limited to economic returns: distributive justice, equality of opportunity and social cohesion are essential goals of government policy, implying the need to maintain adequate levels of social investment even in times of severe economic crises, especially since neglecting these social concerns can have long-term impacts that will become difficult to reverse once they become entrenched.

STATE OF PLAY

Despite the need to maintain or even increase public and social investment for current and especially future growth, as well to deliver social outcomes, there is little flexibility for this in Europe's economic governance framework. While there is a wider discussion on fiscal rules in the governance of the euro area and the potential need for flexibility in applying these rules, this has mostly focused on overall deficit limits rather than specifically on investments.

Measuring social investment

In part, this is due to difficulties in measuring the volume and especially the impact of public and social investment. Quantifying the returns of social investments is tricky since the majority of returns are social rather than economic in nature. In addition, the returns from public and social investment depend on the quality of spending and how effective it is – for example, increasing public sector wage levels may or may not result in a higher quality of public services and better outcomes for individuals. Unless it is possible to clarify and define precisely what constitutes such investments, it opens the door to potential abuses of any preferred treatment of these types of investment in the Stability and Growth Pact (SGP): member states that want to break deficit limits would simply argue that large parts of spending are, in fact, investments. Member states might also be tempted to use arguments around social and public investments as a means to claw back fiscal sovereignty from Brussels; this would, in the end, be detrimental to the functioning of EMU.

Flexibility for investments

To guard against such tendencies, the economic governance framework only allows flexibility with respect to investments in some limited areas – such as EFSI contributions of member states. If these lead to a temporary and slightly excessive deficit, no Excessive Deficit Procedure (EDP) is launched. Outside EFSI contributions, there are very narrow conditions under which investments can receive preferential treatment under the preventative arm of the SGP.⁵

These conditions only apply in very specific circumstances and are insufficient to give member states the necessary breathing space to maintain productive public/social investment in an economic crisis situation, when exceeding the 3% deficit threshold (i.e. countercyclical fiscal policy) would be necessary to counteract the negative impact on growth. More fiscal flexibility to encourage investment may also be needed to address the long-term impact of other social crises. This is demonstrated by the refugee crisis, which has led some governments and regions to ask for more fiscal room for manoeuvre. Furthermore, excluding social investments that are mostly nationally financed – such as education and healthcare – makes this form of flexibility only applicable to a very small part of public investment, most likely excluding those that are most important in creating sustainable growth.

PROSPECTS

A Golden Rule for public and social investment

The importance of social and other productive public investment should be reflected in the SGP. This could be achieved by introducing a Golden Rule, enabling governments – over the economic cycle – to borrow only to invest and not to fund current spending. This would empower member states to maintain productive public/social investments that would otherwise become subject to budget cuts in order to comply with the SGP's deficit targets. A Golden Rule could take many different forms. Maystadt (2014)⁶ for instance proposes to restrict such a rule also to countries that are subject to the excessive deficit procedure and only to projects that fulfil three criteria: European interest, sustainability and profitability – whereby the last criterion would specify some minimum amount of economic return. This profitability criterion could enable the inclusion of (effective) social investment under such a Golden Rule.

Measuring real returns

In order to ensure that public funds, and in particular any additional fiscal space gained through higher flexibility embodied in a Golden Rule, are spent on those projects that have the highest economic and social return, a coherent European measurement framework is needed, to prevent these provisions being abused by countries that are running unsustainable deficits. This framework would need to precisely define both what constitutes a social investment and how outcomes from particular spending areas are stacking up against other spending areas, in order to determine those areas with the highest returns. It would need to be able to measure the return of social investment reliably – in terms of important economic figures such as GDP growth or employment – while ensuring that quantifiable social returns are included and assigned adequate weights in the assessment. The framework should also help to quantify the effect of social investment on reduction of inequality. This could yield more insights into the debate on how economic growth and inequality are linked. For the moment, there is no such framework at EU level that would enable member states and institutions to measure these impacts consistently across countries.⁷

Undoubtedly, creating such a framework will be complex and in the end, uncertainties will remain that will require assessment and decisions by an independent and trusted institution. This could be a role for the European Fiscal Board, which is being introduced under the reforms to the European Semester. For pragmatic reasons, it might also be more straightforward to start with an assessment of which investments can definitely be considered as social investments before establishing the comprehensive measurement framework.

What fiscal space?

Introducing a Golden Rule alongside a measurement framework might contribute to a change of mind in countries such as Germany, which have significant fiscal space, with very low financing costs for public debt, alongside a need for more investments, not least social investments, in areas such as labour market integration of the arriving refugees. Such countries should contribute much more to a European recovery by investing more in (digital) infrastructure, education, childcare and health, which would benefit themselves as well as the Eurozone as a whole. Having convincing evidence that such spending provides a real return could shift attitudes, and incorporating social and public investments more explicitly in the Country-Specific Recommendations (CSRs) in the European Semester process could nudge member states in the right direction. Although, in the end, it is still down to political decisions and preconceptions within each member state.

For those countries that do not have the fiscal space, the range of options are already constrained. Countries that have been hit by the crisis the most generally no longer have sufficient public funds to maintain social investments, let alone increase them. Thus, in addition to allowing for more flexibility in the SGP and incorporating the investment logic in the CSRs, a fiscal capacity is necessary to facilitate (limited) fiscal transfers to be used for productive public/social investments.⁸

No support without conditionality

But if more flexibility in the form of a Golden Rule – as well as a fiscal capacity – is introduced to encourage an increase in social and public investment, this will raise concerns among the countries that need to provide financial backing and that strongly believe that fiscal consolidation continues to be necessary. To make such governance changes politically acceptable, additional flexibility and support must be accompanied by conditionality to overcome the EMU's fundamental political economy problem: while creditors might be willing to provide further support, they fear that reforms are not implemented, resulting in a need for ongoing transfers. Consequently, these countries insist on mechanisms to monitor and enforce reforms. On the other hand, the price of giving up sovereignty for those needing support is often considered too high and is accompanied in many cases by limited institutional capacity to deliver.

Contractual arrangements tied into a revamped European Semester process could be a way of bridging the gap. These contracts could require any financial support to be tied directly to specific structural reforms and/or public/social investments as reflected in the revamped CSRs. However, such contractual arrangements should not be overly bureaucratic or portrayed as a means to exert control from the EU level. Rather, the contractual arrangements should form the basis of an Investment and Reform Pact, which is fully owned by the member state in question.

Towards Genuine Economic and Monetary Union

Introducing additional flexibility in the form of a Golden Rule for public and social investment, accompanied by a European measurement framework, supported by a fiscal capacity and underpinned by contractual arrangements in the form of Investment and Reform Pacts, does not resolve all the structural failings of EMU. In particular, it does not provide a comprehensive solution to the political economy problem of domestic political accountability and legitimacy, coupled with a need for external support vs. European interdependence and the need for effective coordination of economic policies. But it is a step in the right direction and it can contribute, over time, to moving towards a Genuine Economic and Monetary Union as spelled out in the Four- and Five Presidents' Reports.

The alternative is that the euro crisis and the governance solutions that have been introduced to stabilise EMU continue to lead to an under-investment in Europe's future, in particular in its citizens and especially in the countries most affected by the crisis. This will undermine long-term growth prospects, which will, in turn, not only undermine fiscal consolidation efforts but also lead to challenges to European governance and, ultimately, the European integration process as a whole. Taking this first step on social investment could be crucial to start rebuilding trust between Europe's member states, as well as providing evidence to citizens that Europe does take their well-being to heart. Creating a new space for social investment in the economic governance of the Eurozone might well be a crucial turning point in the political crisis that has followed the economic one.

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- 1 Cournède, B., Goujard, A., & Pina, Á., 2014. 'Reconciling fiscal consolidation with growth and equity.' *OECD Journal: Economic Studies*, 2013 (1), 7-89.
- 2 See p. 3 in European Commission, 2013. 'Towards social investment for growth and cohesion – including implementing the European Social Fund 2014-2020.' COM(2013), No. 83 final. European Commission: Brussels.
- 3 Recent studies that find a negative relationship between inequality and growth are for instance Cingano, F., 2014. 'Trends in income inequality and its impact on economic growth.' OECD Economics Department Working Papers, No. 163. OECD Publishing: Paris. or Ostry, J.D., Berg, A., & Tsangarides, C.G., 2014. 'Redistribution, inequality, and growth.' IMF Staff Discussion Note, No. 14/02. International Monetary Fund (IMF): Washington, DC. or Cynamon, B.Z. & Fazzari, S.M., 2013. 'Inequality and household finance during the consumer age.' Working Paper, No. 752. Levy Economics Institute: Annandale-on-Hudson, NY.
- 4 See Krugman, P.R., 2015. 'Musings on inequality and growth.' New York Times - The Opinion Pages. New York Times: New York, NY, 8 Jun.
- 5 For a detailed explanation of these conditions see pp. 8-9 of European Commission, 2015. 'Making the best use of the flexibility within the existing rules of the Stability and Growth Pact.' COM(2015), No. 12 final provisional. European Commission: Strasbourg.
- 6 Maystadt, P., 2014. 'Jump-starting investment.' Fondation Robert Schuman Policy Paper, No. 337. Fondation Robert Schuman: Brussels.
- 7 Such a framework could also set important impulses beyond European policy makers as in addition to governments many businesses and organisations from the third sector use their own metrics that do not allow for consistent comparisons between different actors.
- 8 For a more detailed description of different forms of a Fiscal Capacity see Schneider, J.D., 2015. 'Growth for Europe – Is the Juncker Plan the answer?' EPC Discussion Paper. European Policy Centre (EPC): Brussels, 20 Mar.

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