Importance of public investment for economic growth in the European Union

MANICA HAUPTMAN, MSc

Conference introductory note*
https://doi.org/10.3326/pse.42.2.6

* Received: January 8, 2018
Accepted: January 10, 2018

A conference introductory note presented at the conference "Public Sector Economics 2017 – Public investment: catalyst for sustainable growth" organized by the Institute of Public Finance and Friedrich-Ebert-Stiftung in Zagreb on November 3, 2017.

Manica HAUPTMAN
Economic Counsellor and European Semester Officer, European Commission Representation in the Republic of Croatia, Ulica Augusta Cesarca 4, 10000 Zagreb, Croatia
e-mail: Manica.HAUPTMAN@ec.europa.eu

PUBLIC SECTOR ECONOMICS 42 (2) 131-137 (2018)

1 INTRODUCTION

The economy of the European Union has been recovering steadily from the recent financial crisis, with economic growth returned to all EU member states. Unemployment is at its lowest in nine years, employment rates are growing and long-term and youth unemployment has been declining. Public finances have improved significantly and investment is slowly recovering (European Commission, 2017a:1). Nevertheless, there is some remaining slack in the labour market and, together with slow productivity growth, it obstructs wage dynamics and dampens inflation (European Commission, 2017b:1). Despite the return of more favourable financing conditions, investment has not reached its pre-crisis level and there is still significant potential remaining; the same goes for unemployment.

Some of the EU policy initiatives supporting national and EU public investment have already shown concrete and positive results in terms of increase in investment projects, as well as in terms of the participation of private capital in financial structures also supported by public money. It is important to keep the momentum going and mostly to give enough technical support to every member state to create and manage its own strong project pipeline. The latter together with the supportive regulatory environment remains the key, since the success of any, including of course public, investment depends on the success of the projects it supports.

2 PUBLIC INVESTMENT IN THE EU – STATE OF PLAY

Government debt in EU member states has started to decline from the peak of 87% of GDP during the crisis, but it remains well above the level of 58% of GDP in 2007. As a result of pressure on public finances, public investment in the EU fell from 3.4% of GDP in 2008 to 2.7% in 2016. In a number of member states, the reduction in growth-friendly expenditure has been substantial (European Commission, 2017c:XXI).

Although by 2016 government expenditure had returned almost to the pre-crisis average for 2000 to 2007 (to 46.6% of GDP as against 45.5%), the composition of the expenditure had changed. Public investment (i.e. gross fixed capital formation) amounted to 2.7% of GDP as compared with 3.2% in the pre-crisis period, despite total public expenditure being higher, mostly due to an increase in social expenditure of over 1% of GDP in the same period. [1]

The reduction in public investment is more striking in the EU member states that were hit hardest by the economic downturn (such as Ireland, Portugal, Spain and Greece). Many of these countries have had a high level of social expenditure and high cost of debt servicing, while at the same time "growth-friendly" public expenditure, on R&D and education, for instance, has remained low.[2] Persistently low levels of public investment have a negative effect on the convergence process within the EU. At the same time, the exacerbation of disparities and social diver-

[1] Ibid, pp. 165-166.
[2] Ibid, p. 163.

PUBLIC SECTOR ECONOMICS
42 (2) 131-137 (2018)

gences among EU countries and regions is preventing convergence of the real economy, especially crucial for the euro area.

There are significant differences in the extent of decentralisation of public investment across the EU and in the share of investment managed at regional and local level. The overall tendency has been for public investment spending to become increasingly centralised, whereas there has been little change in the sub-national share of total government expenditure.[3]

It has been recognised at the political level that the EU needs to remove weaknesses in its investment policy. In April 2017, the Eurogroup (European Commission, 2017i) endorsed a list of common principles intended to guide the member states:

- Structural reforms should promote private investment and facilitate resource allocation;
- Productivity-enhancing public investment should be prioritised to boost growth in the short run as well as potential growth in the long run as well as ensuring Stability and Growth Pact compliance;
- Market-based sources of business financing should be developed to widen the range of available forms of financing, especially non-bank sources of finances (e.g. venture capital, crowdfunding and market based finance).

Structural reforms in member states should reflect these common principles and the European Commission is assessing the progress in the framework of the European Semester, the surveillance process of economic governance in the EU as well as in the euro area.

3 INVESTMENT IN HUMAN CAPITAL

One of the most prominent issues in the public investment discourse is the investment in human capital, which is essential for boosting productivity and vital for a resilient economy and economic growth. Investment in quality of education is key to knowledge-intensive and sustainable growth (European Commission, 2017d:1).

Educational attainment in the euro area and the EU has increased over time, but remains heterogeneous across the member states. In terms of quality, Europe is in the midfield rather than a leading world region.[4] Good education systems require appropriate investment. Although the spending on education has been remarkably stable during the years of crisis, its share in government expenditure varies among member states. The EU average share of education within public spending stood at 10.3% in 2015. Education remains the fourth largest government expenditure item after social protection, health and general public services. The ratio of education spending to GDP stood at 4.9% in the EU-28 countries in 2015. In recent years this ratio has stagnated (European Commission, 2017e:11).

[3] Ibid, p. 163.
[4] Ibid, p. 3.

In the context of EU cohesion policy and real convergence, investment in human capital is of the essence. For EU regions to become attractive for investment in higher value-added activities, regions have to improve the quality of their institutions and business ecosystem, become more innovative and improve the skill sets of their labour forces through better education and training. Moving up the value chain requires higher investment per worker than in earlier stages of development, because of the need for a better educated labour force and new business models. Labour-intensive, low-skilled activities need to give way to highly skilled workers to ensure continuous rise in productivity (European Commission, 2017c:25).

Education typically pays off, for both the individual and the society at large. It is mostly funded by public money, which aims to provide equal access to education and lead to more equal income distribution later on (European Commission, 2017d:5).

4 POLICIES AND MECHANISMS AT THE EU LEVEL

The European Commission has been initiating several policy and financial mechanisms to support public investment in its member states.

One of the first initiatives to support jobs and growth was the introduction of the so called "Investment plan for Europe" in 2015, composed of the financial guarantee mechanism "European Fund for Strategic Investment" (EFSI) with backing from European Investment Bank (EIB) own resources and the European Union budget. EFSI has been accompanied by an advisory arm, including technical support for public and private project promotors as well as by a policy pillar, i.e. regulatory reforms, tackling barriers to investment and ensuring a more diverse pool of financing mechanisms in the EU. The main objective of the Investment Plan is to attract private investors, thus participation of the latter in the financing structure of each project or platform is a precondition for applying for EFSI guarantee.

Over the past two years we have seen the launching of hundreds of projects and the macroeconomic impact of EFSI is estimated as increasing EU GDP by 0.7% up to 2020 and providing 700,000 new jobs. In December 2017, the European Parliament and the Council supported the extension of the Investment Plan and therefore EFSI until 2020 (so-called "EFSI 2.0") with increased transparency, more technical support at the local level, greater focus on smaller projects and a larger proportion of sustainable projects including in new areas of sustainable agriculture, forestry, fisheries and aquaculture (European Commission, 2017f).

There have been more and more investment projects combining EFSI with the use of European Structural and Investment Funds (ESIF, or so-called "EU funds"), which brings a new dimension to the cohesion policy and is leveraging EU funds investment with private capital. Cohesion policy and EU funds have undergone regulatory changes recently and pubic investment was at the core of the negotiations on the currently applicable legal framework. One of the major objectives was to improve the consistency of the use of the EU funds and European economic governance (European Semester) rules. Thus programmes and projects financed by EU funds have to be aligned with the country-specific recommendations, including budgetary targets and planned structural reforms. This ensures that the EU public investment is underpinned by sound economic policies (European Commission, 2017c:163).

For more efficient implementation of structural reforms in the member states, a separate service has been established within the European Commission, called the Structural Reform Support Service, which has centralised technical support for reforms, including changes in the regulatory environment and removal of investment barriers.

Concerning budgetary discipline and flexibility under the Stability and Growth Pact (SGP) as part of the economic governance process, there is a possibility of activating a so-called investment clause, which is activated ex ante upon request from member states in their stability or convergence programmes one year ahead of its application. This means in practice that a member state can temporarily deviate from its mid-term objective (i.e. cyclically-adjusted general government budget position) under the preventive arm of the SGP when investment is aiming at, is ancillary to, and economically equivalent to major structural reforms. Such temporary deviation may be granted for the financing of certain specific investments with positive, direct and verifiable long-term budgetary effects on growth and on the sustainability of public finances under certain conditions. The deviation must be linked to the national expenditure on projects co-funded under the Structural and Investment Funds (ESIF), Trans-European-Network (TEN) or Connecting Europe Facility (CEF) and to national co-financing of EFSI backed investment projects (European Commission, 2017k).

5 SOCIAL DIMENSION AND DEEPENING OF THE EU INTEGRATION

The objective of EU and national public investment is not only to increase productivity and achieve sustainable economic growth, but also to support social convergence, with inclusive policies and well-functioning welfare systems in the 21st century EU. In December 2017, the European Council endorsed the conclusions of the Social Summit in Gothenburg to further develop the EU social dimension and to promote convergence through efforts at all levels. The European Council called upon the member states to implement the European Pillar of Social Rights, setting out 20 principles, to facilitate a well-functioning social dialogue at all levels, tackle the gender pay gap and deliver further on the new European Skills Agenda, with a particular focus on "Upskilling Pathways", for people with the greatest skills needs (European Commission, 2017j:2). National public investment in the area of social policies will continue to be supported by the European Social Fund, supporting areas from social inclusion to education and labour markets, as well as efficiency in the public administration and judiciary.

PUBLIC SECTOR
ECONOMICS
42 (2) 131-137 (2018)

Like equal opportunities, social inclusion and protection, the discourse on the deepening of European integration, especially of the European Monetary Union (EMU), remains among the core issues of the debate on the future of Europe and especially of the European Monetary Union. The European Commission set out a roadmap for EMU deepening in December 2017 with several main initiatives, such as the creation of a European Monetary Fund, new budgetary instruments for a stable euro area, including dedicated convergence facility for member states wanting to join the euro area as well as a proposal for a European minister of economy and finance (European Commission, 2017g). The roadmap also foresees the creation of a stabilisation function, bringing together different EU and euro area level funds and financial instruments, to be used to maintain investment levels in the event of large asymmetric shocks (European Commission, 2017h:8), so as to avoid past scenarios of drastically reduced investment levels during an economic and financial crisis.

6 CONCLUSION

Public investment is a crucial part of successful European integration, ensuring sustainable economic growth and economic as well as social convergence. The stimulation of levels of public investment, especially in the current low interest rate environment, remains an EU priority.

REFERENCES

1. European Commission, 2017a. *Annual Growth Survey 2018*. Brussels: European Commission, 22 November 2017. Available at: <https://ec.europa.eu/info/sites/info/files/2017-comm-690_en_0.pdf>
2. European Commission, 2017b. *European Economic Forecast.* Brussels: European Commission, November 2017. Available at: <https://ec.europa.eu/info/sites/info/files/economy-finance/upd_ip063_en.pdf>
3. European Commission, 2017c. *My region, my Europe, my Future: Seventh* EC Cohesion Report. Brussels: European Commission, 9 October. Available at: <http://ec.europa.eu/regional_policy/sources/docoffic/official/reports/cohesion7/7cr.pdf>
4. European Commission, 2017d. *Investment in Human Capital, Assessing the Efficiency of Public Spending in Education*. European Commission note for the Eurogroup, 06/11/2017. Available at: <https://www.consilium.europa.eu/media/31409/investment-in-human-capital_eurogroup_31102017_ares.pdf>
5. European Commission, 2017e. *Education and Training Monitor 2017*. Brussels: European Commission. Available at: <https://ec.europa.eu/education/sites/education/files/monitor2017_en.pdf>
6. European Commission, 2017f. *European Commission Press Release*, 12 December. Brussels: European Commission. Available at: <http://europa.eu/rapid/press-release_IP-17-5169_en.htm>
7. European Commission, 2017g. *European Commission Press Release*, 6 December 2017. Brussels: European Commission. Available at: <http://europa.eu/rapid/press-release_IP-17-5005_en.htm>
8. European Commission, 2017h. *Communication, Further steps towards completing Europe's Economic and Monetary Union: A roadmap*. COM (2017) 821 final, 6 December 2017. Available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017DC0821&from=EN>
9. European Commission, 2017i. *Eurogroup statement on common principles to promote investment*, 7 April 2017. Available at: <http://www.consilium.europa.eu/de/press/press-releases/2017/04/07/eurogroup-statement-investment/ and *Investment in the Euro Area: Common Principles, European Commission note for the Eurogroup*, 4 April 2017. Available at: <http://www.consilium.europa.eu/media/23577/eg-note-investment-common-principles.pdf>
10. European Commission, 2017j. *European Council Meeting (14/12/2017), Conclusions*. Brussels: European Commission. Available at: <http://www.consilium.europa.eu/media/32204/14-final-conclusions-rev1-en.pdf>
11. European Commission, 2017k. Vademecum on Stability and Growth Pact. *European Commission, Institutional Paper*, No. 52. Available at: <https://ec.europa.eu/info/sites/info/files/ip052_en_0.pdf>