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Rethinking EU economic governance: Social investment

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INTRODUCTION

Shortly before the outbreak of COVID-19 in Europe, the European Commission launched a review of the EU's framework for fiscal and macroeconomic surveillance. This review intended to tackle key criticisms of the governance framework, as well as broader challenges like low investment, low growth and missed inflation targets. However, soon after the launch, the General Escape Clause (GEC) of the Stability and Growth Pact (SGP) was activated, thereby suspending the fiscal rules to provide member states with sufficient flexibility to respond to the pandemic.

18 months later, the landscape in which the review recommenced has altered significantly. The pandemic has exposed and worsened inequalities in our societies, reopened wounds from the 2008 financial crisis, and exacerbated divergences within and between EU member states. In responding to the crisis, EU governments have seen debt levels increase and face inflationary pressures. At the EU level, the creation of the (temporary) Recovery and Resilience Facility (RRF) – €338 billion in non-repayable support and up to €386 billion in loans– has broken through previously strongly defended red lines. Depending on its successful implementation, the RRF may well permanently change the debate around establishing a permanent central fiscal capacity at the EU level.

The pandemic has also altered the discussion around investment. To support the twin green and digital transitions, the RRF builds on growing recognition that investments must be made now to prepare for the consequences of climate change. However, it fails to apply the same logic to human capital investment, or 'social investment', in its design. By strengthening people's skills and capacities and supporting them to participate fully in employment and social life, social investment will play a crucial role in rebuilding our economies and societies post-COVID-19 and supporting the twin transitions.

How has the debate around investment evolved? This third Policy Brief in a series on reforming EU economic governance sets out five proposals to promote the role of social investment.

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BACKGROUND

The fiscal rules, in theory

The EU economic governance framework consists of strict fiscal rules that require EU governments to limit their debt levels and budget balances. These rules restrain fiscal stimulus and make no distinction between investments and other public spending. Even if an investment positively impacts GDP growth and therefore contributes to lower debt levels relative to GDP in the long term, the constrained fiscal space means that the investment may be withdrawn if it increases public deficits in the short term.

In 2015, the European Commission used the limited flexibility in the rules to add an 'investment clause' to the framework. This allowed for temporary deviations to the adjustment path towards the medium-term objective, amounting to at most 0.5% of GDP, for a maximum period of three years and under strict conditions. As a result, only two countries, Italy and Finland, have applied the investment clause.[1]

The fiscal rules, in practice

The prevailing environment of fiscal consolidation between the 2008 crisis and the outbreak of COVID-19 in Europe resulted in cuts to public investment throughout most of the EU. According to Eurostat figures, gross government investment in the euro area has declined substantially, with its ratio to GDP falling from 3.6% in 2009 to 2.8% in 2019. Furthermore, investment levels have been negligible in net terms: nearly all gross investment has been replacement investment.[2] Between 2009 and 2012, net public investment in Greece, Portugal, Italy and Spain dropped by more than 2% of GDP, only stabilising in 2012 at a negative level of around -0.5% of GDP.[3]

Despite the investment clause and the additional flexibility, member states – particularly those under fiscal adjustment programmes – still targeted investments for budgetary cuts. Even member states with sufficient fiscal space have been unwilling to invest in future productive capacity. Meanwhile, those member states under fiscal adjustment programmes have spent a decade trapped in a vicious cycle of social deterioration, unable to find sufficient fiscal space to invest in growth-promoting measures and wider social outcomes.[4] This has exacerbated divergences between member states and damaged the resilience of both individual member states and the EU as a whole.

Regardless of the cause, reticence to invest has hampered the EU's economic recovery from the 2008 crisis and levels of growth.[5] Economic theory suggests that increasing public investment has positive demand effects and can contribute to the economy's potential output by increasing the stock of public capital.[6] According to research on the relationship between public capital and growth, the implied marginal returns range from 10% (short run, national, all public capital) to 34.6% (long run, regional, core infrastructure).[7]

Investments in social services (e.g. education and training, childcare, active labour market policies) and social infrastructure (e.g. healthcare and long-term care facilities, educational facilities, social housing) have not been excluded from investment cuts. Instead, they have often been portrayed as luxuries governments can no longer afford.[8] Such 'economic burden' arguments clearly contradict social investment arguments, given that the economic benefits of investments in these particular areas significantly outweigh private and public costs.[9]

Aside from potential economic returns, other benefits of these investments are significant and should not be understated. Social investments make key contributions to other political objectives: the green and digital transitions will not be successful without them. Reduced inequality and child poverty, improved access to the labour market, better health outcomes and social cohesion – these are essential political goals. Neglecting these objectives can have severe negative long-term impacts. There is also a clear political risk to the EU being perceived as – advertently or inadvertently, through the design of the fiscal rules – threatening the well-being and quality of life of its citizens.[10]

STATE OF PLAY

The COVID-19 impact

COVID-19 swiftly and brutally highlighted serious deficiencies in member states' levels of social investment. Nevertheless, member states which maintained higher levels over the previous decade have tended to show greater resilience in the face of the pandemic, having, for instance, better-equipped hospitals, long-term care facilities and schools; more teachers and care staff; and better-performing public services.

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The pandemic has also drastically shifted discussions around the importance of investment. A symmetric crisis (but with asymmetric impact) with no particular blame attached to any single member state resulted in a more coordinated and harmonious response by EU leaders than might otherwise have been expected. The swift activation of the SGP's GEC in March 2020 gave all member states greater leeway to use fiscal means to respond to the unprecedented emergency. The creation of the RRF, which is funded by central EU borrowing and intended to direct investment into the worst-impacted regions, has been a very significant step. For member states with high debt levels, the RRF now presents an opportunity to make additional investments and reforms without affecting the sustainability of public finances in the medium term.[11]

The post-COVID-19 challenges

Nevertheless, the planned deactivation of the GEC in 2023 presents an immediate challenge for investment. Should the fiscal rules be reactivated without amendment, the required fiscal consolidation based on the current adjustment trajectories would be extremely damaging economically, socially and politically. While the RRF allows for high levels of public investment, anxieties over levels of spending are likely to return as its planned end in 2026 approaches. Member states may begin to withdraw support pre-emptively, damaging chances of a successful economic recovery.

But the effects of the pandemic on inequality, poverty and territorial disparities have been – and continue to be – vast, and some of the scarring will not be fully visible for some years. Reforms and investments are needed to tackle these challenges and to strengthen the EU's socio-economic resilience. The European Commission's estimate of the additional investment needs in social infrastructure is €192 billion per year, with healthcare and long-term care accounting for 62%.[12]

Besides the COVID-19 challenges, demographic change also remains a significant threat to the sustainability of care and social protection systems, to economic growth and to Europe's position in the world. The total cost of ageing in the EU is projected to account for 26.6% of GDP by 2070.[13] The accelerating climate and biodiversity crises also require massive additional investment. For the EU to achieve its climate and digital goals, €520 billion will be needed annually over the next decade.[14]

PROSPECTS

The reform options

Considering the discussions of the EPC's Rethinking EU Economic Governance Task Force, the wider literature and public debate, five broad categories of reform proposals emerge.

1. **Alter the pace of fiscal consolidation**
   With all member states under an Excessive Deficit Procedure, a low adjustment path (e.g. 0.1% of GDP) should be set, with a sizeable window to make the necessary adjustments. The pace of consolidation would then increase in line with economic growth. Adjustments should take place with due regard to the targets in the European Pillar of Social Rights Action Plan. These targets should also form a central part of a reformed European Semester process, building on the RRF's lessons.

   Such a trajectory would diminish fears of returning to austerity, with its severe impact on economic growth, employment and social cohesion. Furthermore, fiscal consolidation through growth is far more effective than via cuts in expenditure. Allowing a slower pace of fiscal consolidation would provide space for investments that boost future growth, thereby being a more effective approach to achieving consolidation.

2. **Reassess the accounting procedure for public investments**
   A reassessment of the public accounting treatment of public and/or social investment to account for, inter alia, the return on different types of social investment should be undertaken by an external organisation, such as the Organisation for Economic Co-operation and Development. This may encourage a reassessment of the definitions of public investments versus current public spending at the national level. In the long run, this could redefine the national income identity –

   GDP = C (consumption) + I (private investment) + G (government spending) + NetEx (net exports)

   – to split government investment from government spending. This reassessment should improve the quality of public finances overall, ensuring that member states and the EU prioritise investments that should improve the long-term fiscal (and social and environmental) trajectory of an economy.

   By building the theoretical framework this way, mechanisms like golden rules could be applied in the future, as the reassessment will provide the yardstick for distinguishing between real investments and relabelling for the sake of flexibility.

3. **Establish a Future Investment Fund**
   In order to encourage investment within the current SGP framework, member states should be encouraged to establish a 'Future Investment Fund'. The public investment within this fund would be excluded from the calculations of both headline and structural deficits so that net public investment is financed via debt. These funds should pay due attention to the country-specific recommendations issued under the European Semester and target their investments accordingly. The European Commission would supervise these funds, as it does the RRF.

   The EPC Task Force members felt that social investment must be prioritised alongside investments into the twin transitions, as it will be a crucial tool to improve EU competitiveness, strengthen social resilience and smooth the negative impact of the transitions.

   While disagreements on definitions and how to measure returns have often hampered past discussions on promoting social investment, the Task Force did not feel that they are impossible to overcome. As similar definitions are required for green or digital investment and are not viewed as an insurmountable obstacle, and as definitions have already been constructed for other public investments (e.g. road construction), these disagreements do not override the many benefits of promoting a social investment approach.

4. **Reform the European Semester**
   The reform of the European Semester must demonstrate that the lessons of the 2008 crisis have been learnt and that social outcomes will be prioritised alongside fiscal and public administration reforms. The Task Force felt that there were many positive lessons to be taken from the RRF regarding country ownership, financial incentives attached to reforms, the identification of clear targets, country specificity

and its multiannual scope. Nevertheless, as with the Semester, the lack of clear targets for social objectives, limited opportunity for dialogue when formulating the National Recovery and Resilience Plans, and the often relatively centralised process (at the national level) must be addressed in future reforms.

Considering the centrality of the green and digital transitions within the RRF and the importance of social investment to support these, a fully integrated scoreboard combining economic, social and environmental indicators should monitor member states' progress. This scoreboard would support the Commission's Beyond GDP agenda, which seeks to develop indicators as clear as GDP but more inclusive of environmental and social aspects of progress.

5. **Prioritise what matters to citizens**
Moving towards a net-zero Europe will not happen without first constructing a coherent narrative that builds broader societal consensus, counters populist arguments and includes citizens in the net-zero transition. As a start, discussions from the Conference on the Future of Europe should feed into economic governance revision. Having a clear understanding of what people consider to be most valuable – even if it challenges the existing economic orthodoxy – will provide a compass against which decisions can be appraised. A reformed economic governance framework must look beyond purely numerical fiscal targets and aim for ecological, social and economic well-being. Clear targets must be set for these ambitions, with their achievement tied to EU funding, and the progress measured by the integrated scoreboard suggested above.

Prospects for consensus

Although the EPC Task Force recognised that only a full reform of the EU's economic governance framework would address some of the most deep-seated criticisms, it agreed that this is currently unlikely. It felt, however, that there is sufficient flexibility in the EU treaties to make the requisite changes to better support social investment.

The pace of fiscal consolidation is likely to be a key point of contention in reform discussions, with disagreements between those who view the reduction of debt burdens as the most urgent objective and those fearing rapid fiscal tightening undermining the COVID-19 recovery. Nevertheless, the Task Force broadly agrees that a longer-term perspective in economic governance would be beneficial. This may also support the calls for greater social investment, which often has a longer-term return, and so is currently not prioritised by member states urgently needing to reach adjustment targets.

The growing consensus on the need for fiscal space for green and digital investments suggests that the mantra of austerity has now shifted. Nonetheless, there remain concerns that the incremental progress made over the past decade in reshaping the European Semester to pay due attention to the social implications of economic and fiscal policy requirements will now be lost. The RRF's limited social perspective and the vocal calls to 'unburden' the Semester process suggest that its increasingly horizontal perspectives are perceived to be either complicating or diluting this key tool of EU economic coordination. However, only by integrating a full scope of policy areas into this mechanism will there be a significant simplification of the process, and a concrete step taken towards achieving the Commission's Beyond GDP agenda.

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