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The Golden Rule of Public Investment
Protecting fiscal leeway and public infrastructure in the EU

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Georg Feigl and Achim Truger

Georg Feigl is an economist at the Chamber of Labour, Vienna, and Achim Truger a professor at the Berlin School of Economics and Law and senior research fellow at the Macroeconomic Policy Institute, Düsseldorf.

Policy recommendations

We propose implementation of a Golden Rule of Public Investment as a much needed institutional reform and an important step aimed at overcoming the constraints imposed by the new European Economic Governance. The Rule in question is widely accepted in traditional public finance and can deliver both intergenerational fairness and jobs. As such, it is important to modify at least the application of the European fiscal rules in order to allow net public investment to be financed by deficits, complemented by temporary expansionary fiscal policy in times of economic hardship with especially high unemployment. Although a fully-fledged implementation of the Rule would take some time, this should not be an excuse for not making use of pragmatic short-term solutions which are readily available at the European level.

Introduction[1]

The Eurozone economy is still very far from recovery – as measured by pre-crisis unemployment levels – so that the need for a change of macroeconomic policy would seem to be staring us in the face. However, until October 2012, when the IMF came up with new evidence stating that fiscal tightening had had a greater negative impact than expected, rather few voices had been raised in open criticism of the European economic policy. Subsequently, the calls for a more expansionary fiscal stance, above all by a boosting of public – or publicly supported – investment, became louder and more urgent. As a first consequence, since spring 2013 European fiscal policy has become less restrictive, at least in the non-programme EU countries.

The substantial drop in public investment is one of the negative side-effects of the new European Economic governance (see, for example, Feigl 2014) which is based on the belief that member states' economic policies should be restricted by tough rules designed to restore confidence. As a result of this belief, policy makers find themselves trapped by new rules which prevent them from taking adequate fiscal policy action to bring down both unemployment rates and debt levels.

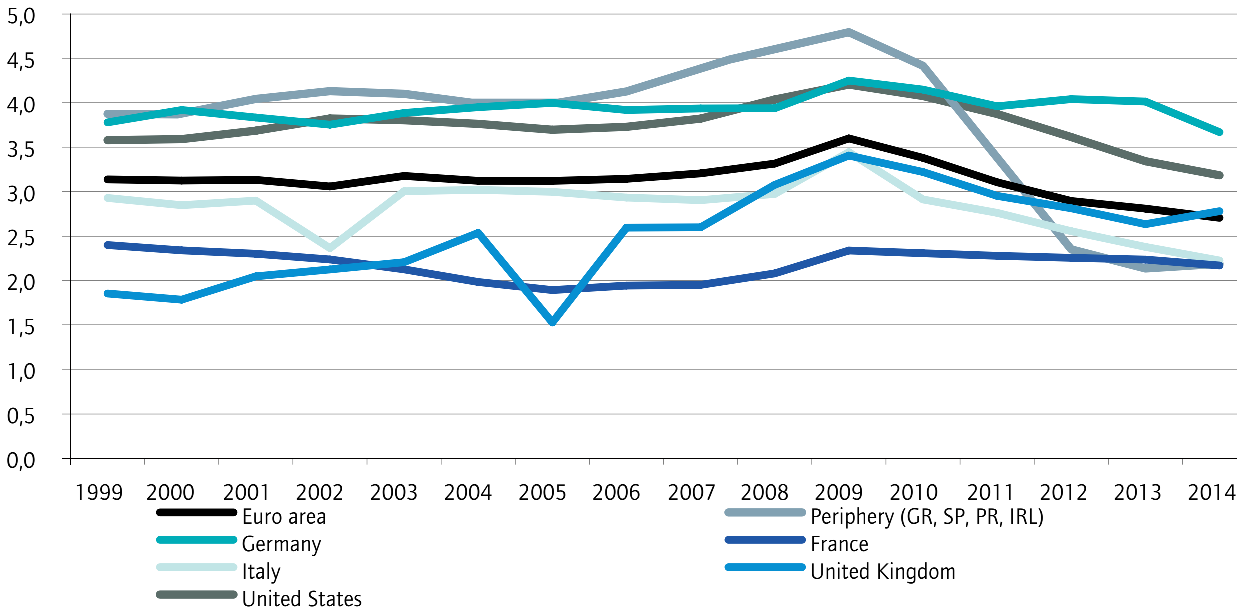
Since a curtailing or postponement of public investment does not usually provoke outspoken political resistance insofar as such investment is not a mandatory form of expenditure, cuts in this area have been the strongest feature of austerity policies.

Accordingly, although public investment is the most effective fiscal policy instrument for boosting economic growth (see Gechert 2015), it has entered a severe decline. The economic damage caused by investment cuts, in terms of deepening and prolonging the economic crisis, has been substantial. Furthermore, as many studies in the current literature find public investment to be growth-enhancing in not only the short but also the long run (see for example Bom and Ligthart 2014), the neglect of public investment will in all likelihood reduce the growth potential of the Euro-area economy and thereby inflict harm on future generations.

After the European elections, president Juncker proposed a plan to fight the European investment slump. The problem with the European Fund for Strategic Investment (EFSI), which is at the centre of the new Investment Plan, is the analytical failure of continuing to neglect the negative effects on investment of the strict fiscal rules imposed within the EU over recent years. Although some projects might be found to be constrained by credit supply or the investment environment, the crucial problem

1 This policy brief is based on the longer study written by Truger (2015a).

Figure 1 **General government gross fixed capital formation in the Euro area, the Periphery and selected countries (% of GDP), 1999-2014**



Data source: European Commission (AMECO-Database May 2015).

of weak domestic demand is not addressed. Furthermore, insofar as the Investment Plan requires public co-financing, options that would help to redress this demand remain blocked by the tough budget restrictions imposed by the Stability and Growth Pact (SGP) and the Fiscal Compact. Another problem is the lack of new financial resources dedicated to boosting the EFSI; its resources consist merely of 'old' money creatively leveraged to 105 billion Euros on average for this and the next two years. Even if the Juncker Initiative were to succeed to the extent hoped for by the European Commission (EC), total investment would still remain far below its pre-crisis level. The amount would be barely enough to compensate for the drop in public investment for, based on the latest economic forecast by the EC, the projected drop in the gross-public-investment-to-GDP ratio in the Eurozone (from 3.4 % in 2010 to 2.5 % of GDP in 2016) is approximately €100 bn. Thus, even if the EFSI were – a rather unlikely scenario – to become a success story, a more expansionary fiscal stance, consisting principally in the boosting of public – or publicly supported – investment, should nonetheless be placed firmly on the agenda.

The Golden Rule for Public Investment and the arguments in its favour

The effectiveness of investment for stimulating growth and the special threat posed by austerity in this respect are tried-and-tested tenets of economics. For more than half a century, the standard solution in traditional public finance has been the so-called *golden rule*, as developed and advocated notably by the economist Richard A. Musgrave. This Rule states that net public investment – increases of the public and/or social capital stock providing future benefits, e.g. gross public investment minus depreciation – should be financed by debt, in other words, excluded from balanced-budget rules. Such an exemption can help to protect public investment in times of austerity (see IMF 2014: 110-111), as cuts in public investment cannot then be used to reach a specified consolidation target.

However, the main arguments deployed in favour of a Golden Rule for Public Investment are quite other, namely those of intergenerational fairness and economic growth. Starting out from the pay-as-you-use-principle, such a Rule is the solution for generating benefits in the long run, as debt financing is the only way of ensuring that future generations not only benefit from past investment in public buildings, rail- and motorways and so forth, but also contribute to the costs of these goods and amenities. Net public investment increases the public and/or social capital stock and provides benefits for future generations. Awareness of this fact justifies the demand that future generations should contribute, via debt servicing, to the investment in question.

Failure to allow for debt financing of future generations' benefits will lead to a disproportionate burden for the present generation through higher taxes or lower spending, creating incentives for the under-provision of public investment to the detriment of future generations. There is evidence that this under-provision has indeed been characteristic of periods of fiscal contraction – not only during the current crisis, but also in relation to the decline in public investment observed during previous crises (Turrini 2004: 9-26).

A special case of this problem is posed by rapidly growing cities (Amsterdam, Brussels, Madrid, Milan, Munich, Vienna and so forth) which require a high level of investment merely to maintain the current public capital stock per capita. If the public infrastructure has to be financed exclusively by taxpayers already living in the cities for the benefit, principally, of their future inhabitants who are not yet born or have not yet arrived (Himpele 2015), the risk of under-provision is especially high. With the reinforcement of European fiscal rules leading to stronger pressures on the public sector at the sub-national level and therefore to rapidly decreasing levels of liabilities per person, it will be very difficult, in the absence of some means of allowing borrowing for investment, to maintain – not to speak of increasing – the current stock of public infrastructure per person.

A further argument in favour of the Golden Rule can be made by way of comparison with the private sector. In private companies investment is not entered into the operating results, but only into the category of depreciation. In the current fiscal framework, this provides an incentive for private-public-partnerships, as they can be used as vehicles for splitting cases of high one-off expenditure into smaller pieces of current public expenditure in order to circumvent the fiscal rules. However, this entails the disadvantage of usually higher transaction and financing costs[2] as compared to the original public investment solution that is prevented by the legal and accounting rules.

How to reform the EU fiscal framework in the medium term to accommodate implementation of the Golden Rule

Implementing the Golden Rule of Public Investment would thus be an important reform towards improvement of the EU fiscal framework. The current framework, insofar as it severely restricts debt financing of public investment, is economically nothing less than irrational. We show, additionally, that some of the problems typically used as arguments against implementation of this Rule, namely, the definition of public investment and dangers to debt sustainability (see for example Turrini 2004), can be quite easily dealt with.

It is true that establishing a proper definition of public investment can be difficult. In economic terms, the most plausible definition of a Golden Rule for Public Investment would focus on those government expenditures that provide substantial future payoffs in terms of higher growth or avoided future costs. This definition would in some respects be narrower and in others more encompassing than the standard definition of public investment in the national accounts: it would be narrower because military weapon systems, which have just been included in the recent revision of the system of national accounts, would have to be again excluded, as being non-growth-enhancing in the long run; it would be more encompassing, because some types of public expenditure, most importantly on education, but also some types of social preventive spending, e.g. social investment (Buxbaum 2015), would have to be classified as growth-enhancing or beneficial for future generations.

As the classification of educational and other expenditures as public investment stands in need of further elaboration and clarification, the Golden Rule should, as a first step, be introduced for traditional public investment as defined in the national accounts minus military spending. The Rule should apply to net investment, i.e. depreciation should be deducted, in order for it to allow proper measurement of increases in the net public capital stock. As such, standard national accounts provide all the necessary data for technical implementation of the Golden Rule. And as Gechert (2015) and Bom and Lightart (2014) have shown, one can be confident that the type of public investment thus promoted would, on average, be growth-enhancing in both the short and the long run. On similar grounds, the – conservative – German council of economic experts (SVR) has also proposed the introduction of a Golden Rule in its concept for a German 'debt brake' and stated that, although the growth-enhancing effect cannot be measured exactly, the solution of a complete ban on investment-related borrowing due to measurement uncertainties would be a worse alternative (SVR 2007: 80).

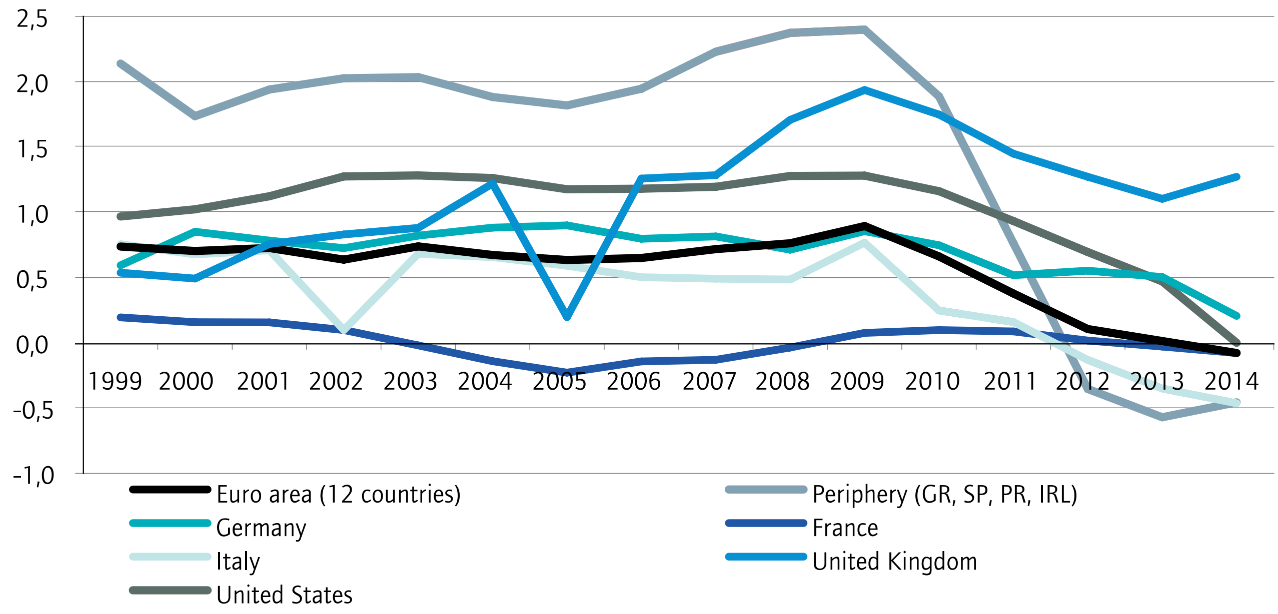
The focus on net investment has the further advantage of providing a strong incentive for those governments currently providing negative net public investment, i.e. whose public capital stock is decreasing. Under the approach advocated here, net public investment would not have to be counted in the relevant deficit measures of the Stability and Growth Pact (SGP) and the fiscal compact.

Another possible objection to the adoption of a Golden Rule is that it can undermine debt sustainability. However, as we show, the two can be compatible, provided that the parameters for implementation of the Rule are appropriately set. At the moment, the strictest fiscal rule at EU level in normal times is the medium-term objective, i.e. a structural deficit of 0.5 % of GDP or less. Although very high net investment rates of more than 2% of GDP per year are unlikely in the long run, such levels could theoretically threaten debt sustainability, at least in times of crisis. In order to prevent a conflict between the Golden Rule of Public Investment and the goal of stabilising public debt at below 60% of GDP, an upper limit of deductible net investment spending of 1 or 1.5% of GDP could be set. If the future nominal growth rate were around 3.5% per year (projected potential growth rate of 1.5% plus 2% inflation target), even a net investment ratio at the upper limit of 1.5% would lead to a long-term convergence of the public debt below the 60% of GDP threshold[3]. Implementation of the Golden Rule of Public Investment would probably take some time, pending completion of the necessary political and legal steps; a change in the institutional fiscal framework would most probably be required for firm implementation of the Rule and this could take the form of an 'Investment Protocol' under the simplified revisions procedure of Article 48 of the Lisbon Treaty. As such, the Golden Rule should be regarded principally as a fiscal policy framework focused on safeguarding public investment in the medium term, and not so much as a readily available instrument for providing the – urgently needed – boost to the European economy in the short run.

2 Due to complex contracts prepared by external consultants and lawyers as well as in general higher risk premia of private companies and a mark-up to earn profits.

3 This is calculated using the well-known formula that the nominal debt-to-GDP ratio in the long run converges to the ratio of the deficit to GDP divided by the expected average nominal GDP growth rate, i.e. 2/3.5 = 0.5714, where the deficit of 2% of GDP is comprised of the standard 0.5% permissible under the fiscal compact plus 1.5% of GDP as net investment expenditure.

Figure 2 **General government net fixed capital formation in the Euro area, the Periphery and selected countries (% of GDP), 1999-2014**



Data source: European Commission (AMECO-Database May 2015).

Approximating the Golden Rule and creating leeway for expansionary fiscal policy right now

Approximation to the Golden Rule for Public Investment could be achieved over the coming period, even without any changes in the current legislative framework, if the European Commission and the European Council were willing to use the interpretational leeway existing within this framework in order to change the code of conduct on the implementation of the SGP. There are essentially three elements in the current legislation which could be used as justifications for the Golden Rule: first, Article 126 TFEU, which obliges the European Commission to 'take into account whether the government deficit exceeds government investment expenditure' while preparing a report on the existence of an excessive deficit; secondly, the *investment clause* in the preventive arm of the Stability and Growth Pact introduced in 2013, which allows for temporary deviations from structural objectives – but only under very restrictive conditions, making it not very useful in practice; lastly, the general leeway given by a number of possibilities for commonly agreed exceptions (especially in the case of the new debt rule) and unclear specifications (e.g. the method to be used for estimating the structural deficit).

That a more expansionary interpretation of the current fiscal framework is possible was recently shown by the European Commission: besides the instruments for financing private investment, the Junker Plan introduced, in January of this year, some minor changes in interpretation of the fiscal rules. First, the investment clause has been expanded, but without any corresponding changes in the overly restrictive conditions. Secondly, in economically bad times – defined as a negative output gap bigger than 1.5% – the adjustment path towards the MTO has been softened to some extent, although this has not hitherto played a decisive role in practice. Thirdly, member states implementing structural reforms are allowed to temporarily use an extra margin of up to 0.5% of GDP for major structural reforms with 'direct long-term positive budgetary effects, including by raising potential sustainable growth' (EC 2015: 10).

Although none of the three changes have had an important impact on the national fiscal space allowed by the fiscal rules, they showed how quickly application of the SGP can be changed. If the EC and/or relevant players in the Council can be mobilised, some progress is possible, although this leeway will not be enough to provide a truly positive fiscal stimulus. However, compared with the additional fiscal pressure examined by discretionary political decisions in 2011 and 2012 (compare Feigl 2014), a less restrictive policy already constitutes some progress.

Further progress could be made in that additional net investment could be justified if it came in the form of a temporary investment programme, analogous to the way in which the Commission interprets contributions to the EFSI. Additionally or alternatively, it may be possible to treat an investment programme as a structural reform, allowing for temporary deviations from MTO or the adjustment path towards it. As with the investment clause, it should be possible, under these conditions, to implement it as a 'small-scale golden rule'. All of this could be further supported if realistically high multiplier values were to be used in assessing the budgetary impact of additional investment, which may not be significantly negative and might even be positive. This would mean that such additional investment could be irrelevant, at least under the excessive deficit procedure, as it would not (or would hardly) increase the deficit. A reasonable reconsideration of the EC's method of cyclical adjustment aimed at increasing the cyclical part of the budget deficit, thereby reducing the structural deficit, may create further leeway especially in the countries in crisis (Truger 2015b).

Probably the most convincing way of allowing for a fiscal (investment) boost would be to use the provision concerning a severe downturn in the Euro area or the EU to justify a temporary deviation from the consolidation path, thus allowing for a substantial European Investment Programme. The Commission has explicitly made a comparison with the 2008 European Economic Recovery Plan to give an example of the potential use of this provision (EC 2015: 17). As a condition for the use of this provision, it 'should remain limited to exceptional, carefully circumscribed situations to minimise the risk of moral hazard' (EC 2015: 17). It may well be argued that the Euro area is currently in precisely such an exceptional situation after several years of recession and stagnation.

One option for the direction of the programme would be to use it in order to start phasing in traditional net public investment up to the desired level after the final implementation of the Golden Rule. Alternatively or additionally, such a programme could also be used to allow for investment needs beyond the narrow national accounts definition to contribute to public investment in a broader sense (compare Aiginger 2014). This could be investment in education, including child care, but it could, more generally, focus on spending with a view to achieving some of the currently neglected Europe 2020 goals such as social inclusion or other areas that have been severely damaged as a result of austerity in recent years.

Towards a more reasonable economic policy?

To sum up, a Golden Rule indeed has, in our view, some particular advantages. Unlike proposals intended to provide more leeway for fiscal policy in general, it provides particular support for public investment as an essential element of public spending. Unlike the Juncker Plan, it provides a direct boost to public investment on the national level. Moreover, it does not have to rely on highly insecure shifting and leveraging of public funds on the European level in the hope of finding private investors at a time when business confidence is extremely low.

However, the Golden Rule for Public Investment is above all a fiscal policy tool focused on safeguarding public investment in the medium term and not so much on providing the – so urgently needed – boost to the European economy right now. Therefore, pressing for observance of the Rule should be complemented by pushing for a short-term European Investment Programme similar to the European Economic Recovery Plan adopted during the Great Recession. Such a programme could also provide for investment needs in a broader sense, beyond the narrow national accounts definition. This could be investment in education, including child care, but the focus could be, more generally, on spending geared to achieving some of the currently neglected Europe 2020 goals such as social inclusion or other areas adversely affected by so many long years of austerity. Last but not least, the fiscal stimulus thus provided should not be thwarted by simultaneous cuts in other areas of public expenditure. Instead, the leeway within the current institutions should be actively used to provide a substantial fiscal stimulus to the European Economy.

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