Implementing the golden rule for public investment:

Safeguarding public investment and supporting the recovery

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Prof. Dr. Achim Truger

Berlin School of Economics and Law

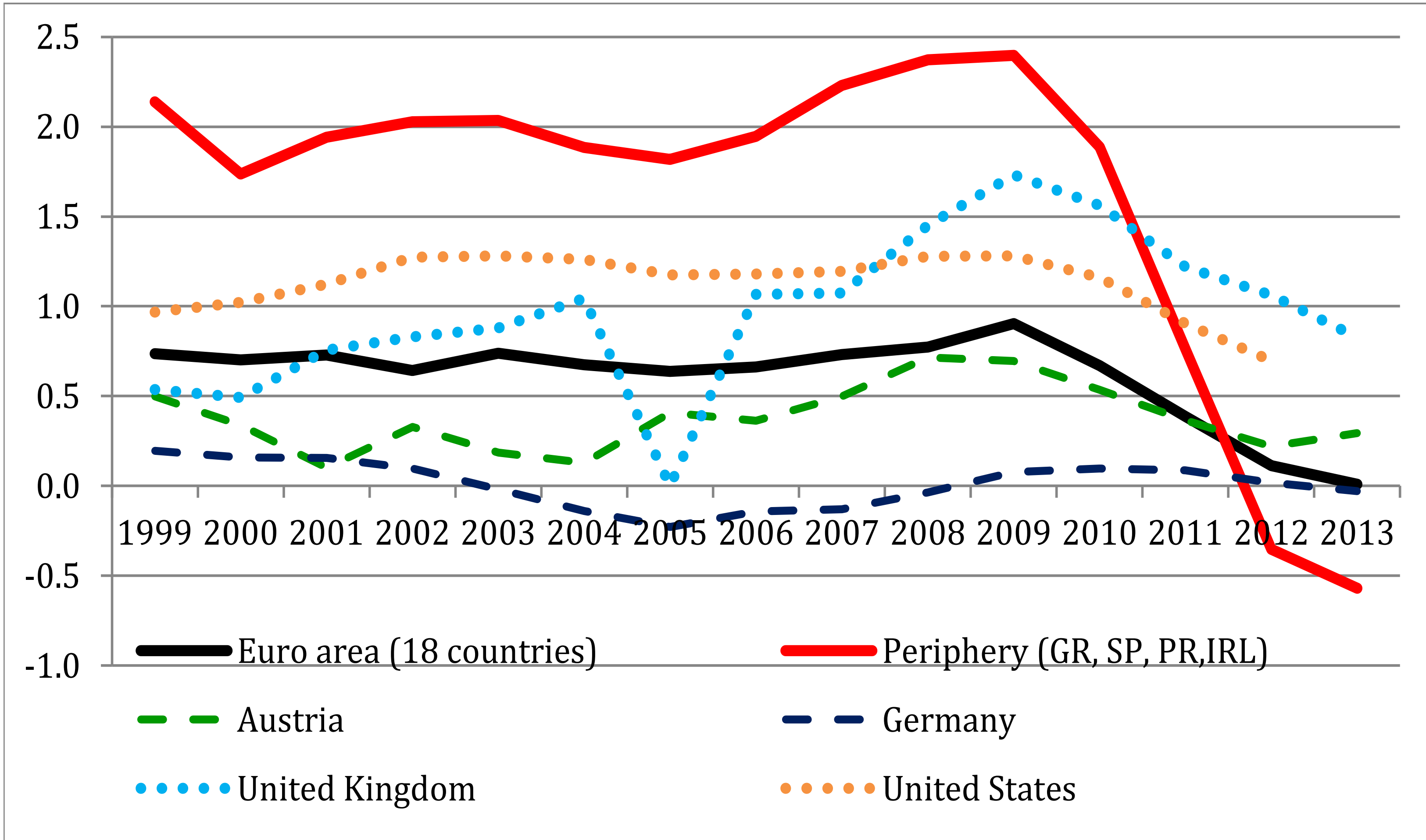
Hochschule für
Wirtschaft und Recht Berlin
Berlin School of Economics and Law

Overview

- **austerity and the neglect of public investment in Europe**
- **the golden rule for public investment**
  - the goal: intergenerational fairness + growth
  - towards a pragmatic definition of public investment
- **Germany and the UK as counterexamples?**
- **ways of implementing the golden rule within the EU fiscal framework**

…the neglect of (net!) public investment

Figure 4: General government net fixed capital formation (ESA 2010) in the Euro area, the European Periphery and selected countries in per cent of GDP, 1999-2013



Source: European Commission (2014a); author's calculations.

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the golden rule for public investment

net public investment investment should should be financed by budget deficits

the reasons: intergenerational fairness & growth

- net public investment increases the public/social capital stock
- future generations inherit higher capital stock, productivity and growth
- pay-as-you-use principle: future generations contribute to financing via debt service
- otherwise present generations have to pay all of the burden
- **otherwise: incentives for underinvestment, particularly in times of budgetary pressure**

proponents of the golden rule

- Richard A. Musgrave (1939/1959)
- **as reform for EU fiscal policy**
  - Fitoussi/Creel (2002); Blanchard/Giavazzi (2004)
  - Barbiero/Darvas (of Bruegel) (2014); Dervis/Saraceno (2014)
- **in German debate about the ‚debt brake'**
  - German council of economic experts (the 5 wise women/men) (2007) proposed the golden rule in their blueprint for the debt brake
  - interestingly Michael Hüther (2013), president of IW Köln, the economic research institute close to the German industry federation called the strict deficit limit of the German debt brake into question, because it may not allow sufficient public investment

defining public investment

Theoretically, any expenditure with a sufficiently high future return should qualify as investment

➔ **find expenditure categories that qualify on average**

- **traditional investment as defined in the national accounts?**
- spending on education?
- spending on child-care?
- spending on social work and integration?

defining public investment

traditional investment as defined in the national accounts

- mainly tangible assets (construction, infrastructure, equipment, office machines, other capital goods with an economic life of more than one year)
- substantial short-term growth effects
  - new ‚multiplier' debate: multiplier substantially larger then 1
  - Larger than for other spending categories and particularly than revenue-side measures
- substantial long-term growth effects
  - high rates of return

defining public investment

Table 1: Implied marginal returns to public investment in per cent.

	all public capital		core public capital	
	Regional	**national**	**regional**	**national**
short term	17.4	10.2	24.0	16.8
long term	28.0	20.8	34.6	27.4

Source: IMF (2014: 86); Bom and Ligthart (2014: 907-908); author's calculations.

defining public investment

traditional investment as defined in the national accounts

- after general revision of national accounts (ESA 2010)
  - includes spending on research and development
  - includes spending on military weapons systems
  - counts more firms/non-profit organisations as part of the government
- should be corrected for spending on weapons systems (-) and investment grants to private sector (+)
- depreciation should be deducted to focus on net investment

➔ **pragmatic definition of net investment**

theoretical optimality is the wrong standard

"Despite these limitations it would be exaggerated to completely discard the golden rule with recourse to the inconveniences of reality. Investment related borrowing may meet the requirements of the golden rule but in an imperfect manner so that a really convincing concept cannot be realized in its pure form. However, a complete ban of investment related borrowing cannot even be underpinned by a theoretically plausible argument."

(German council of economic experts 2007: 80; author's translation)

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Germany and UK as counterexamples?

- **Germany had ‚golden rule‘ from 1969 to 2009**
- **UK had golden rule from 1997 to 2009**
- **UK golden rule was suspended in the crisis**
- **Germany abolished it and introduced the constitutional ‚debt brake‘**
- **confession of failure?**
  - too lax to avoid increase in debt to GDP-ratios?
  - not binding etc.

Germany and UK as counterexamples?

confession of failure?

- **no: the increase in the debt level had different reasons**
  - UK: huge burden of financial crisis
  - Germany: huge burden from unification and crisis (more than 26 %-points of debt ratio in 2010)
- **no: both rules suffered from specific problems and were ill-designed in some respect**
  - Germany: (gross investment, financial accounts, transgression easy, weak enforcement)
  - UK: balancing the budget over explicitly dated cycle too ambitious

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Implementing the golden rule in the EU fiscal framework

- **deduct net public investment from relevant deficit numbers of the stability and growth pact**
  - i.e. from headline deficit relevant for corrective arm
  - i.e. from structural deficit relevant for preventive arm
- **set upper limit to deductible net investment of 1 to 1.5 % of GDP to ensure sustainabilty**
  - apply limit as a percentage of net investment rather than as a threshold to really protect investment as a whole
  - transition period for member states with presently negative net investment

Implementing the golden rule in the EU fiscal framework

- **current Commission approach to fiscal policy (less strict interpretation of SGP + Investment Fund)**
  - is considerable progress as necessity of action is ackowledged
  - is not enough as expansionary fiscal stance instead of merely less restrictive stance is needed
  - is not enough as success of Investment Fund is very doubtful and would take time
    - why should private firms invest?
    - Why should public firms/governments invest?

Implementing the golden rule in the EU fiscal framework

- **current Commission approach to fiscal policy is insufficient (less strict interpretation of SGP + Investment Fund)**
- **implement golden rule of public investment in the medium term (probably Treaty change or at least unanimous Council decision necessary)**
- **in the short term strengthen investment (silver rule) and ensure expansionary overall fiscal policy stance within the current fiscal framework**

Strengthen investment („silver rule“, Aiginger)

- **Use severe downturn for a boost to public investment**
- **2-3 years minimum 1 % of GDP stimulus per year**
- **Investment can be more broadly defined to enhance short term feasibility and stimulus with high employment impact**
- **E.g. spending on neglected Europe 2020 goals**
  - research and education,
  - early childhood investment, child care
  - infrastructure maintenance and upgrading,
  - ecological renovation of homes and offices,
  - bottlenecks in energy and broadband grids

10 ways to strengthen investment + boost fiscal policy

goals	measures
short term (use interpretational leeway within present framework to come close to the golden rule of public investment)	
strengthening investment + expansionary overall fiscal policy stance	(1) more active use of the 'investment clause'
	(2) allow for temporary investment programmes (analogous to EFSI)
	(3) interpret temporary investment programmes as structural reforms
	(4) incorporate realistic investment multiplier in budgetary analysis ex ante
	(5) use leeway in economically bad times
	(6) implement better methods of cyclical adjustment
	(7) temporarily higher spending with a view to Europe 2020 goals
	(8) use exception for severe downturn in EU or Euro area
medium term (solid implementation of the golden rule of public investment)	
EU implementation	(9) 'investment protocol' as annex to the Treaty (simplified revisions procedure Art.48)
national implementation	(10) change national legislation to allow deduction of net public investment from deficit where necessary

Thank you very much for your attention!