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Policy Brief

A coordinated mix of public investment and incomes policies for sustainable development in Europe

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Abstract: This policy brief presents the impact of a coordinated policy mix of increased public investment together with more progressive taxation and labour market policies to improve income distribution in Europe. Based on an econometric model for individual EU Member states, we simulate a policy scenario of a simultaneous increase in public investment by 1% of GDP along with more progressive taxation (increasing effective tax burden on capital by 1% and decreasing tax burden on labour by 1%) and an increase in the wage share by 1% of GDP in each country. The result is 6.6% higher GDP in the EU. Even private investment increases by 1.5% as a ratio to GDP (on average in Europe) as an outcome of this policy mix; i.e. public spending does not crowd out but rather crowds in private investment. Despite the rise in public spending, the budget balance in Europe improves (by 0.8% as a ratio to GDP) because the beneficial fiscal effects of higher economic growth and higher tax rates on capital prevail. Growth and private investment improves both in the periphery and core countries of Europe. The concerns regarding the inflationary effects of wage increases are also not supported by empirical evidence. This policy mix will lead to only a modest 1.5 percentage point increase in price level in Europe on average. Hence wage-led and public investment-led growth are complimentary and feasible. Such a coordinated policy mix, along with a properly designed industrial policy can ensure genuine regional convergence and social cohesion in Europe.

Keywords: public investment, wage share, wage-led growth, incomes policies, progressive tax, equality-led development, Europe

JEL codes: C23, D22, G31

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A coordinated mix of public investment and income policies for sustainable development in Europe

Austerity policies coupled with rising inequality in Europe have resulted in a prolonged stagnation. The way to end this vicious circle of chronically low demand, slow down in investment and productivity, and economic, social and political instability requires a coordinated action mobilising fiscal and incomes policies in all the EU Member States.

Our recent research presents the impact of a coordinated policy mix of increased public investment together with more progressive taxation and labour market policies to improve income distribution in Europe (Obst, Onaran and Nikolaidi, 2017). Based on an econometric model for 15 individual EU Member states, we simulate a policy scenario of a simultaneous increase in public investment by 1% of GDP along with more progressive taxation (increasing effective tax burden on capital by 1% and decreasing tax burden on labour by 1%) and increase in the wage share by 1% of GDP in each country. The result is 6.6% higher GDP in the EU.

As a result of this policy mix, private investment increases as well by 1.5% as a ratio to GDP (on average in Europe); i.e. overall public spending does not crowd out but rather crowds in private investment despite a rise in tax rates on profits. Despite the rise in public spending, the budget balance in Europe improves (by 0.8% as a ratio to GDP) because the beneficial fiscal effects of higher economic growth and higher tax rates on capital prevail.

The concerns regarding the inflationary effects of wage increases are also not supported by empirical evidence. Our policy mix leads to only a modest 1.5 % increase in the price level in Europe on average. In fact, a wage stimulus would help to keep the European economy away from deflation.

Growth, private investment and budget balance improve both in the periphery and core countries of Europe.[1] The effects of this policy mix on GDP are strongest in Finland (11.7%), Greece (14.5%) and Spain (15.5%).[2] GDP increases by more than 2% in all countries: e.g. by 5.8% in Denmark, 6.6% in Germany, 5.1% in France, 2.68% in Ireland, 3.8% in Italy, 7.3% in Portugal, 9.7% in Sweden and 4.5% in the UK.

Hence, expansionary fiscal policy is sustainable when wage and public spending policies are combined with progressive tax policy; the impact is stronger when these policies are implemented in a coordinated fashion across Europe due to strong positive spill over effects on demand. Such a coordinated policy mix, along with a properly designed industrial policy can ensure genuine regional convergence and social cohesion in Europe.

Combining egalitarian labour market and tax policies with public spending policies are important not only for achieving higher growth, investment and sustainable debt levels but also for other important social targets, such as lowering carbon emissions via green investments or improving gender equality via public spending in social infrastructure. Similarly, public investment policies are key to achieving structural change, higher productivity in tradable sectors and keeping trade balance under control while still managing an egalitarian economic model. To reinstate the missing link between private investment and profits, Europe needs directed public

[1] Only in Greece and Ireland this policy mix does not improve the budget balance, though the impact on the budget is negligible, and the gains in terms of growth and private investment are substantial in these countries too.

[2] These countries had high differences in marginal propensity to consume, no significant effect of profit share but significant government expenditure effects on private investment. See Table 9 in Obst, Onaran, Nikolaidi (2017) for details.

investment policies accompanied by a properly designed industrial policy, along with higher equality and stimulated demand, and regulation of finance and corporate governance.

A wage-led development strategy requires the use of both pre-distributive as well as re-distributive policies. Pre-distributive policies can aim at improving the market distribution of income by a variety of policies to build institutions and re-regulate the labour market, improve the union legislation, increase the coverage of collective bargaining, and enforce equal pay legislation more effectively.[3]

Finally, coordination of wage policies at the European level is crucial to ensure that wages increase in line with historical increases in productivity to stabilise effective demand, avoid counter-productive beggar thy neighbour policies, and prevent a race to the bottom. In the Euro area, this implies that wage policy has to take into account current account surpluses as much as deficits and coordination must aim at avoiding a deflationary adjustment with substantially higher wage growth in the surplus countries, while also aiming at convergence in productivity through active investment policies (Onaran and Stockhammer, 2016).

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[3] Guschanski and Onaran (2016) estimates that a rise in minimum wages, or changes in labour market and trade union and collective bargaining legislation to increase the bargaining power of unions are very effective policies to offset the negative impact of technological change or globalisation on the wage share in Europe. The results are robust, if the wage share excluding the income of the top 1% of the waged and salaried people are used as the dependent variable.