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INVESTMENT IN THE EURO AREA: COMMON PRINCIPLES

(Note for the Eurogroup)

Executive summary

The discussion in the Eurogroup of 11 July 2016 highlighted that the euro area has a specific interest in addressing barriers to investment in order to support the rebalancing process. Ministers concluded by asking the Eurogroup Working Group (EWG) to work further on three key areas of relevance to investment (i.e. the efficiency of public administration, the business environment and sector-specific regulatory bottlenecks) with a view to the elaboration of common principles and subsequently on possible benchmarking. All topics were covered in previous thematic discussions and this note focuses on the common principles aimed at guiding the necessary reform efforts for removing investment bottlenecks in euro area Member States.

Addressing investment weakness through a mix of demand and supply policies can boost growth (in short and medium-long term), improve the resilience of the monetary union, increase the cyclical convergence of the Member States' economies and foster the rebalancing process within the euro area. Three common principles for investment are identified:

- (i) Reforms should aim at facilitating resource reallocation and, in particular: (a) improve the business environment; (b) improve the quality of public administration, (c) address sector-specific bottlenecks and (d) improve the responsiveness of the labour market;
- (ii) high-quality public investment should be prioritized to boost growth in both short run and medium-long run;
- (iii) market-based sources of business financing should be developed.



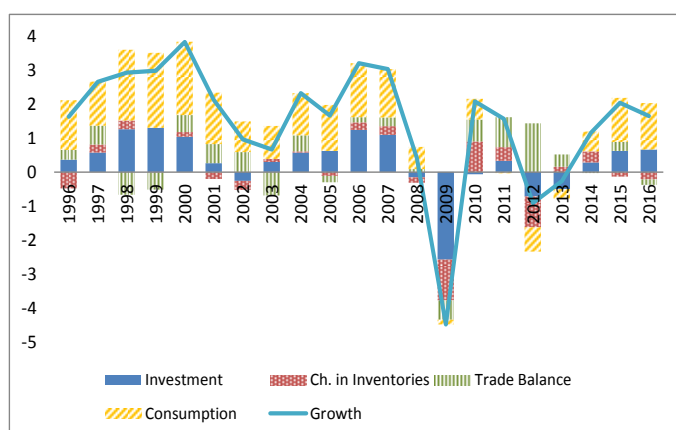
Beyond reforms that can directly affect investment, additional policies are essential to successfully implement these principles. In particular, great attention should be given to measures fostering a well-functioning justice system, fighting corruption and promoting more transparent, open and efficient public procurement.

In order to turn these common principles into practice, actions are needed both at EU level and at Member State level, also with a country-specific approach. At EU level, the Investment Plan focuses on making smarter use of new and existing financial resources, through the European Fund for Strategic Investments – EFSI (first pillar), providing visibility and technical assistance to investment projects (second pillar) and removing obstacles to investment (third pillar). Further deepening the Single Market remains a priority: this involves the Single Market Strategy and completing the Digital Single Market, the Capital Markets Union, the Banking Union and the Energy Union. Furthermore, the Better Regulation agenda is aimed at slashing red tape and improving the law-making process. At Member State level, fiscal policies should aim for an appropriate balance between the need to ensure sustainability and the need to support investment to strengthen the recovery, while ensuring compliance with the Stability and Growth Pact (SGP). Furthermore, in the context of the third pillar of the Investment Plan, euro area Member States need to identify the main barriers to investment and to prioritise actions for removing them.

1. The economic rationale for boosting investment in the euro area

Boosting investment is crucial for economic growth in the euro area. The recovery in the euro area is continuing at a moderate pace, and investment still shows signs of weakness, especially in countries heavily hit by the crisis.¹ GDP is now higher than before the crisis and the employment rate has increased, also benefitting from the reforms adopted in a number of Member States. However, the contribution of investment to growth remains low (see Graph 1) and the investment rate is still below the pre-crisis average.² In spite of improved financing conditions, investment is held back by persistent sluggishness in demand, by legacies inherited from

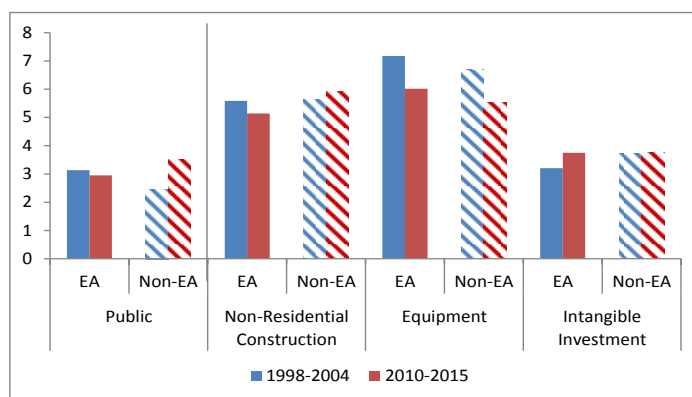
Graph 1. Contributions to GDP growth



Source: AMECO.

the crisis, as well as by structural deficiencies dating back to the pre-crisis years. In several Member States, non-performing loans, high private and public debt and deleveraging processes, as well as the ongoing balance sheet repair in the banking sector continue to weigh on investment. At the same time, some Member States with persistent current account surplus still have a record of low total investment compared to their economic fundamentals.³

Graph 2. Investment by sector and type, euro area and non-euro area (% GDP)



Source: AMECO. Note: weighted averages. (1) Non-Residential, Equipment and Intangible include both private and public investment. (2) Non-EA does not include Croatia due to lack of data on investment by type.

Most categories of investment in the euro area decreased except intangibles, which proved to be resilient to the crisis. Public investment in the euro area, as a share of GDP, has been persistently weak since the onset of the crisis, while it has increased in non-euro area countries (see Graph 2).⁴ Moreover, it remains on a slight decline on aggregate, contributing to the overall weakness of investment in the euro area. Turning to investment by category, investments in equipment and non-residential construction remain particularly

¹ See European Economic Forecast- Autumn 2016, European Economy Institutional Paper 038.

² See Graph A1 in annex 1.

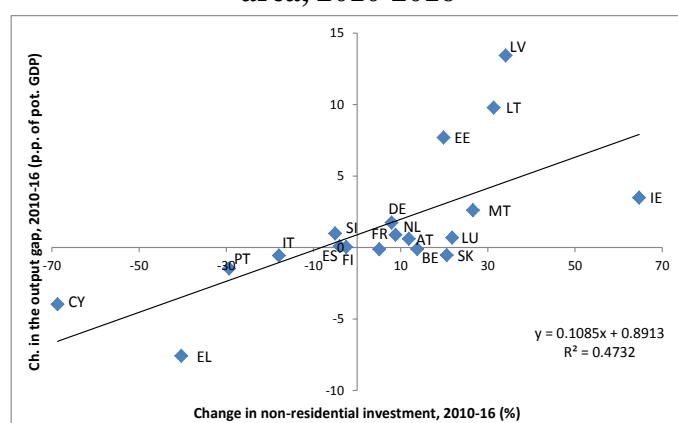
³ In Germany, however, recent agreements on reforming the federal fiscal relations should increase the scope for public investment, alleviating barriers to investment in infrastructure at municipality's level.

⁴ Private investment is, instead, still significantly below the pre-crisis average both in euro area and non-euro area countries. In many Member States, the private sector is still deleveraging, hampering expansion of private consumption and investment. It should be stressed that, in a number of countries (e.g. cohesion countries, both in the euro area and non-euro area), EU funds contributed in part to the resilience of public investment since the crisis.

weak. On a positive note, investments in intangibles in the euro area have proved particularly resilient, even compared with non-euro area peers.⁵ Different types of investment affect growth in different ways: for example, public investment can, among other things, help to correct market imperfections that cause underinvestment. Investments in equipment and infrastructure increase the productive capacity of the economy. Finally, investments in intangibles have a crucial role for growth and productivity especially in developed economies like the euro area, and higher levels of investment in these assets are generally associated with higher growth rates of GDP per capita.

Improving the conditions for investment can foster cyclical convergence, which is of key importance for the euro area. Investment developments, in particular non-residential investment, have been different across euro area countries since the crisis. This contributed to the cyclical divergence within the EMU over the past years (see Graph 3).⁶ Removing obstacles to investment and improving cyclical convergence, in turn, can raise the effectiveness of other macro-economic and structural policies in the EMU. In particular, expansionary monetary policy and initiatives aimed at facilitating access to finance (e.g. the Capital Markets Union) are less effective if financial markets are fragmented and barriers to firms' investments persist.

Graph 3. Investment and output gaps in the euro area, 2010-2016



Source: AMECO. Non-residential investment includes: construction other than dwellings; equipment; other investment (i.e. intangible).

Fostering cyclical convergence, in turn, can improve the resilience of the euro area. Resilience implies that Member States have a low vulnerability to shocks and/or a high degree of flexibility to adjust to economic shocks. Moreover, in a monetary union, the adjustment after a common shock should be as homogeneous as possible. In this respect, the speed of recovery after the crisis has been very diverse across the euro area. While the overall euro area gross national income (GNI) was above the pre-crisis level only by 2015, in some Member States (Belgium, the Netherlands) the GNI had already recovered by 2010; at the same time, in a number of countries, the GNI still lingers significantly below the pre-crisis level (Italy, Finland, Portugal, Greece, Slovenia, Cyprus). In a resilient monetary union, given the absence of the nominal exchange rate as an adjustment tool, the reallocation of capital and labour in response to asymmetric shocks needs to be smooth. While strengthening the adjustment capacity of the euro area, smooth resource reallocation can also foster investment.

In addition, a pick-up of investment can contribute to a sustainable rebalancing process within the euro area. This issue is relevant both for net debtor and creditor countries. For example, investment that contributes to boost exports and improve non-cost competitiveness is crucial for countries with large external liabilities. At the same time, in some surplus countries, the large current account surplus also reflects weak

⁵ Investment in intangibles include education and training, public and private scientific research, business expenditures for product R&D, market development, and organizational and management efficiency.

⁶ See "Growth differences between EA Member States since the crisis", QREA Vol.13 N°2, 2014.

investment or high savings compared to economic fundamentals. Stronger investment and/or consumption would not only contribute to foster domestic growth, also provide a positive impulse for nominal growth in other euro area countries.

2. Principles for promoting investment in the euro area

<i>Principle 1: Reforms should aim at facilitating resource reallocation</i>

Smooth resource allocation is crucial to boost investment. Competition-enhancing reforms improve the functioning of product and labour markets by making them more reactive and flexible. Moreover, resource reallocation can boost productivity, growth and resilience. Market flexibility facilitates the reallocation of productive resources (capital, labour) towards the most productive firms and sectors, fostering investment and, in case of shocks, enhancing its adjustment capacity. Lowering barriers to competition enables more productive firms to grow while allowing less productive ones to exit the market in an efficient manner. Smooth resource reallocation is even more important for euro area Member States, since they do not have the tool of monetary policy to absorb country-specific shocks. The heterogeneity in terms of business environment among euro area Member States suggests there is room for further progress.⁷ Excessive rigidities can undermine the cohesion of the common currency area by hampering the convergence of its economies.

This principle encompasses four subprinciples:

a. Improve the business environment

Efforts should be placed in decreasing the cost, the time and the number of procedures needed to start and formally operate a business (also across borders); facilitating firm entry, exit and growth; simplifying the framework conditions conducive to further expansion of firms (also across borders); increasing the effectiveness and efficiency of the insolvency framework; and finally decreasing the time and cost needed to export. Actions should also be taken to modernizing business and sector specific regulation, improving enforcement mechanisms for commercial contracts and preserving protection of minority shareholders.

b. Improve the quality of public administration

Reforms should aim at improving the efficiency of public service delivery, as well as the efficiency and transparency of tax collection. Specifically, several key elements of effective public administration need to be ensured, namely: ensuring the availability of e-government services; reducing the legislative uncertainty, implementing competition law effectively; stimulating the coordination of public investment across levels of government (e.g. through an integrated strategy).⁸

c. Address sector-specific bottlenecks

This subprinciple applies specifically to services and utilities (e.g. regulated professions, retail and network), which still face high restrictions. Efforts should be made in reforming the regulated professions and business services, also diminishing the number of regulated professions; facilitating retail permits and speedy provision of construction permits; and integrating spatial planning into investment policies.⁹

⁷ See "Single market integration and competitiveness report 2016", European Commission 2016.

⁸ See European Commission (2015). "Quality of Public Administration: A toolbox for Practitioners" European Commission. Directorate-General for Employment, Social Affairs and Inclusion.

⁹ See the SWD (2015)400 final/2 for an identification of the relevant sector specific bottlenecks for Member States. See also Graph A.2 in annex 1 on investment challenges in Member States.

d. Improve the responsiveness of the labour market

Reforms should facilitate geographical and job mobility and increase the incentive for the unemployed to find a job. Intervention needs to focus on reducing skills mismatches between the workforce and firms' needs and providing for access to qualified workforce.

Principle 2: High-quality public investment should be prioritized to boost growth in both short run and medium-long run

In the current juncture, public investment can play an important role to support demand in the short run and potential growth in the longer term. An intensification of public investment efforts can, as a component of aggregate demand, sustain the ongoing recovery. This is especially the case under a zero-lower bound environment, since fiscal multipliers of higher public investments tend to be larger under an accommodative monetary stance. In the longer run, effective public investment can increase the productive capacity of the economy and lead to an increase in potential growth and productivity. Furthermore, it can leverage private investment, potentially increasing efficiency thanks to better risk sharing and incentives to perform: public-private partnerships are an example in this regard. The quality of the governance system for public investment is crucial in determining the choice of investment priorities which, ultimately, influence its short- and long-term impact. Carefully-designed investment strategies shall be implemented to make sure that economic considerations are applied in the selection of productive investment projects and in the financing decisions.

Member States' fiscal policies should aim for an appropriate balance between the need to ensure sustainability and the need to support investment to strengthen the recovery, as per the Recommendation on the economic policy of the euro area adopted by the ECOFIN in March 2017¹⁰. Member States that are at risk of not meeting their obligations under the SGP in 2017 should take, in a timely manner, additional measures to ensure compliance. Conversely, Member States that have outperformed their medium-term objectives are invited to continue to prioritise investments to boost potential growth while preserving the long-term sustainability of public finances. Member States that are projected to be broadly compliant with the SGP in 2017 should ensure compliance with it within their national budgetary processes. Overall, Member States should improve the composition of public finances, by creating more room for tangible and intangible investment.

Investment in network infrastructure contributes to growth, and the role of public investment, alone or in partnership with private investment, is essential. Investment in network industries, especially in transport, energy and digital infrastructures, can have positive multiplier effects provided there is no overprovision.¹¹ Network infrastructure plays an important economic role, as service provider and input to the rest of the economy. For example, energy networks, broadband and transport infrastructure provide essential inputs for production and deliver services for consumers. Here public investment can play a role to ensure universal service, security of supply and/or promote new technologies. Finally, investment needs in these areas are huge given the EU targets to be achieved by 2030.

Public investment can play a crucial role for knowledge-intensive and sustainable growth. Education spending can increase the productivity and employability of the

¹⁰ See Outcome of the 3527th Council meeting. Economic and Financial Affairs Council, March 21st 2017.

¹¹ See European Commission (2014) "Infrastructure in the EU: Developments and Impacts on Growth", European Economy, Occasional Papers 203 | December 2014.

workforce, sustaining potential growth and competitiveness. In this regard, the quality of the education plays an important role. Similarly, reducing skill gaps (i.e. mismatches between available skills and skills that are or will likely be looked for by employers) may enhance the employability of the workforce. Granting subsidies or tax expenditures that increases the incentive to invest by the private sector can also stimulate total investment in the economy. Indeed, incentives for investment in R&D are particularly common across euro area Member States. At the same time, private investment in R&D seems to be higher in countries with higher public R&D spending.¹² Finally, investment in skills can address the industrial transformation and the need to adapt to changes in the labour market.

Principle 3: Market-based sources of business financing should be developed

Having more diversified sources of financing is good for investment, and also essential for financial stability. The availability of different forms of financing – including venture capital, crowdfunding and market-based finance – can mitigate the potential impact of difficulties in the banking sector on the rest of the economy and on firms' access to finance. For example, a high level of non-performing loans (NPLs) and slow balance sheet adjustment in some countries contributed to further deteriorate the already weak investment in the euro area since the crisis. Problems in the banking sector also contributed to the appearance of relatively large cross-country spreads in lending rates during the crisis. Moreover, reflecting a high reliance on the banking sector of businesses in the euro area, the corporate sector in some countries remains highly leveraged exposing it to future adverse shocks. Excessive reliance on bank financing is an issue especially for small and medium-sized enterprises (SMEs), young innovative firms and start-ups.

SMEs, young innovative firms and start-ups in particular often struggle to get funding from banks for their investments (due to higher perceived risks). SMEs, young innovative firms and start-ups can increase innovation and competitiveness, strengthening the economy. Moreover, high-growth firms are more able to stimulate employment compared to other firms. For these firms in particular, it is important to have access to market-based sources of finance, complementary to bank financing, such as crowdfunding, venture capital and private equity, private placements and issuance of debt and equity securities. Young innovative firms, start-ups and established SMEs often lack collateral or have short-term cash flow constraints, which makes access to finance particularly challenging.¹³

The availability of non-bank sources of financing can improve the resilience of euro area firms in the face of an adverse shock and contribute to the better functioning of the monetary union. Intra-EU cross-border investment was lacklustre over 2015 and the first half of 2016 and has not yet attained pre-crisis levels. Thus, there is an urgent need for further policy actions at EU and national level to support equity financing and tackle barriers to cross-border activities in the EU. The Capital Markets Union (CMU) will play an important role in this respect. The CMU Action Plan adopted in September 2015 aims to diversify the sources of finance for businesses, particularly SMEs, and infrastructure projects, create more investment opportunities for retail and institutional investors and to foster cross-country investment. Building integrated capital markets as part of the CMU requires action at EU level, but also at national level. The CMU mid-term review in June 2017 will provide a good opportunity to review progress on the implementation of the CMU and set priorities going forward, in a changing economic

¹² See "Research and innovation as sources of renewed growth", (COM(2014) 339 final).

¹³ See "Europe's next leaders: the Start-up and Scale-up Initiative", (COM(2016) 733 final).

and political context.¹⁴ Member States should take decisive commitments to tackle national barriers – including legislative ones – to the development of capital markets and to the cross-border flow of capital. For instance, the market for start-up financing is currently fragmented and still functioning below its potential. The growth of market-based forms of financing in the past years shows that the market has been severely underserved. Furthermore, financial regulation has to be conducive to investment while avoiding excessive risks taken in the past.

3. Flanking policies: how to make these principles successful

Beyond reforms that can directly affect investment positively, additional policies are necessary to address the weakness of investment in the euro area. This is the case, in particular, of policies aimed at improving the quality and governance of public institutions. In some countries, minimum standards might need to be achieved as pre-conditions to their improved attractiveness to investment.

- **Measures for an effective judicial system.** Effective judicial systems are a prerequisite for an investment- and business-friendly environment because they increase confidence of domestic and foreign investors in case of litigation. Well-functioning judicial systems positively affect lending, because creditors are more likely to lend and firms are dissuaded from opportunistic behaviour, they also reduce transaction costs and foster investment from innovative businesses. The key components of an effective justice system are: quality throughout the entire judicial process; independence, assuring the fairness, predictability and certainty of the legal system in which businesses operate; and efficiency, as timely decisions are essential for business, investors and consumers.¹⁵ Improving enforcement capacity of national administrative authorities is also essential for the effective functioning of the whole enforcement chain.¹⁶ Insolvency frameworks are also of key importance: defining procedures for dealing with insolvent debtors can have ex-ante and ex-post economic effects as they shape private agents' incentives.¹⁷
- **Fighting corruption.** An effective fight against corruption is an important element of a business environment conducive to investment. Apart from distorting competition, corruption also generates uncertainty in the business environment, slowing down processes, creating additional costs, ultimately deterring investments from foreign investors.¹⁸ Corruption diverts resources away from economically productive outcomes, undermining the sustainability of public budgets and reducing the public funds available for investment, especially in times of constrained public resources.¹⁹ Increasing the transparency and the integrity in the public sector means ensuring a more efficient tax collection and public spending, while consolidating the rule of law. This can boost competition in the market for goods and services, diminish barriers to

¹⁴ A public consultation was open until 17 March.

¹⁵ The EU Justice Scoreboard and country-specific assessments feed into this process. See "European Semester Thematic Factsheet – Effective Justice Systems" and the 2016 EU Justice Scoreboard (COM(2016) 199 final).

¹⁶ See "EU Law: Better Results through better Application", (2017/C 18/02).

¹⁷ See "Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures", (COM(2016) 723 final). The note to the Eurogroup on "Insolvency Frameworks in the Euro Area: Efficiency Principles and Benchmarking" identifies a number of core principles with regard to insolvency frameworks.

¹⁸ See "European Semester Thematic Factsheet – Anti-corruption", European Commission (2016).

¹⁹ OECD (2013), "Issue Paper: Corruption and Economic Growth".

trade and investment and encourage private business commitment to a long-term development strategy.²⁰

- **Promoting more transparent, open and efficient public procurement.** Transparency in public procurement can contribute to increase the degree of competition in order to ensure that the companies that win are the ones with the best product at the best price. To be transparent, the information on the public procurement process must be available to everyone (contractors, suppliers and the general public). Public procurement must also be efficient, encompassing different aspects such as a responsible management of public funds, so that the price paid for goods and services is reasonable and reflects their quality.²¹ Moreover, central purchasing bodies could contribute to stimulate growth and innovation by procuring a fraction of their large procurement volume in innovative goods and services.²²

²⁰ In its Communication on the Single Market Strategy, the Commission highlighted the importance of tools to fight corruption and improve the governance of public funds. See COM(2015) 550 final.

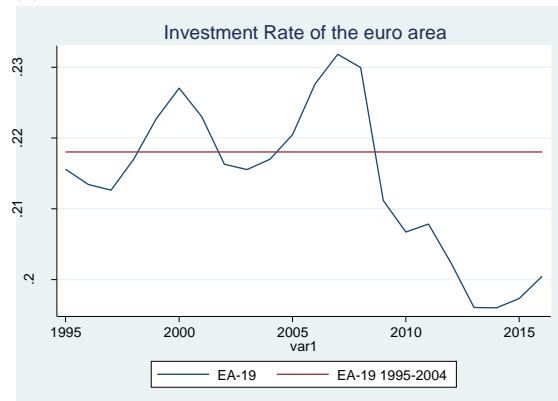
²¹ For example, the use of quality criteria integrated in the Most Economically Advantageous Tender (MEAT) principle should, in general, be preferred to the lowest price as an award criterion.

²² See "European Semester Thematic Factsheet – Public Procurement", European Commission (2016).

Annex 1

Graph A1: The euro area "investment gap"

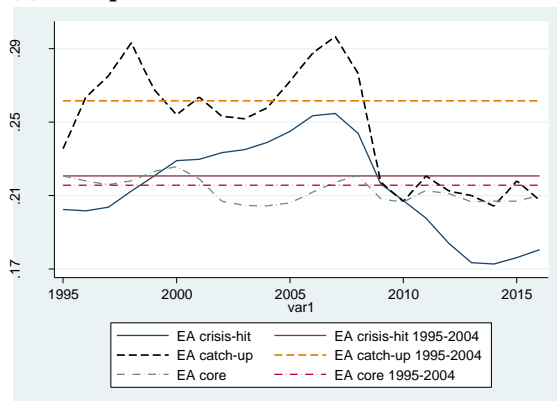
(a) Euro area as a whole



Source: AMECO.

Note: The investment rate is calculated as Gross Fixed Capital Formation over GDP. The pre-crisis average 1995-2004 is chosen so to exclude the years 2005-2007 where the construction bubble in some countries reached its peak.

(b) Groups of countries



Source: AMECO.

Note: Country groups are as identified in the July 2016 EG note "Thematic discussion on Investment". "EA crisis-hit" includes IT, ES, IE, EL, PT, CY. "EA catch-up" includes MT, EE, LV, LT, SI, SK. "EA core" includes DE, FR, AT, BE, NL, FI.

Graph A2: Progress with addressing investment challenges

Investment Challenges		AT	BE	BG	CY	CZ	DE	DK	EE	ES	FI	FR	HR	HU	IE	IT	LT	LU	LV	MT	NL	PL	PT	RO	SE	SI	SK	UK
Public administration/ Business environment	Regulatory and administrative burden																											
	Public administration																											
	Public procurement /PPPs																											
	Judicial system																											
	Insolvency framework																											
	Competition and regulatory framework																											
Labour market/ Education	EPL & framework for labour contracts																											
	Wages & wage setting																											
	Education, skills and life-long learning																											
Financial Sector / Taxation	Taxation																											
	Access to finance/Weaknesses to the financial sector																											
R&D&I	Cooperation between academia, research and business																											
	Financing of R&D&I																											
Sector specific regulation	Business services / Regulated professions																											
	Retail																											
	Construction																											
	Digital Economy / Telecommunications																											
	Energy																											
	Transport																											
		<div>No progress</div> <div>Limited Progress</div> <div>Some Progress</div> <div>Substantial Progress</div> <div>Fully addressed</div>																										

Source: European Commission – Investment challenges identified in the 2017 Country Reports (covered by a Country-Specific Recommendation or not).

Note: The table does not include Greece which is subject to a macro-economic assistance programme